

University of Warwick institutional repository: <http://go.warwick.ac.uk/wrap>

A Thesis Submitted for the Degree of PhD at the University of Warwick

<http://go.warwick.ac.uk/wrap/67150>

This thesis is made available online and is protected by original copyright.

Please scroll down to view the document itself.

Please refer to the repository record for this item for information to help you to cite it. Our policy information is available from the repository home page.

EFFICACY OF CORPORATE GOVERNANCE THEORIES IN DETERMINING THE REGULATORY FRAMEWORK FOR ISLAMIC FINANCE INSTITUTIONS

By

SHEHARYAR SIKANDER HAMID

A thesis submitted in partial fulfilment of the requirements for the
degree of Doctor of Philosophy in Law

University of Warwick, Department of Law November 2014

CHAPTER1. INTRODUCTION

1. INTRODUCTION.....	1
2. AIMS.....	3
3. BACKGROUND.....	3
4. LAYING THE GROUND WORK: ISSUES, CHALLENGES AND SOLUTIONS.....	5
5. METHODOLOGY.....	14
6. THE THEORETICAL FRAMEWORK.	15
7. CONCLUSION.....	19

**CHAPTER 2: AN INTRODUCTION TO ISLAMIC SOURCES OF LAW
AND THE SCHOOLS OF THOUGHT AND THEIR RELEVANCE TO
MODERN DAY ISLAMIC FINANCE**

1. INTRODUCTION.....	21
2. SHARIAH AND ITS MEANING.....	22
3. PRIMARY AND SECONDARY SOURCES OF ISLAMIC LAW	23
4. FATWAS AN INTRODUCTION.....	26
5. ISLAMIC LAW SCHOOLS AND THEIR LEGAL AND SOCIO-ECONOMIC EFFECTS ON MODERN DAY ISLAMIC FINANCE.....	27
6. THE BASIS OF ISLAMIC FINANCIAL INSTRUMENTS: A SHORT INTRODUCTION TO ISLAMIC CONTRACT LAW.....	31
I. INNOMINATE CONTRACTS AND STIPULATIONS (<i>SHURUT</i>).....	34
II. OBJECT OF CONTRACT.....	38
7. THE CONCEPT OF HALAL (LAWFULL AND ALLOWED) AND HARAM(UNLAWFUL AND BANNED).....	40

8. USING THE CONCEPT OF MAQASID AL SHARIA AND MASALAH AS A SOURCE OF SHARIA	43
9. RIBA AND GHARRAR: AN INTRODUCTION	47
10. RIBA	47
11. THE SUBSTANCE OVER FORM DEBATE: THE RIBA CONUNDRUM.....	52
12. GHARRAR	54
13. CONCLUSION.....	58

CHAPTER 3. THE ISLAMIC ECONOMIC SYSTEM AND THE IMPLICATION FOR BUSINESS ETHICS, LAW AND GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS

1. INTRODUCTION ISLAMIC BUSINESS ETHIC.....	60
2. OBJECTIVES AND AIMS OF AN ISLAMIC ECONOMIC AND FINANCIAL SYSTEM.....	67
a. ACHIEVEMENT OF FALAH(WELFARE).....	67
b. FAIR AND EQUITABLE DISTRIBUTION: JUSTICE (ADALAH).....	70
c. PROMOTION OF BROTHERHOOD AND UNITY	75
d. ACHIEVEMENT OF MORAL AND MATERIAL DEVELOPMENT	77
3. BASIC PRINCIPLES OF ISLAM.....	79
a. TAWHID.....	79
b. TRUSTEESHIP (KHILAFAH)	81
c. ECONOMIC FREEDOM	83
4. FUNDAMENTAL PILLARS OF ISLAMIC BUSINESS AND ECONOMIC MODEL.....	85
iii. PILLAR ONE: PROPERTY RIGHTS.....	86

iv.	PILLAR TWO: THE OBLIGATION DERIVING FROM CONTRACTS.....	88
v.	PILLAR THREE: THE RIGHT TO PURSUE INDIVIDUAL ECONOMIC AIMS.....	89
vi.	PILLAR FOUR: ATTAINMENT AND DISTRIBUTION OF WEALTH.....	90
vii.	PILLAR FIVE: RISK SHARING.....	91
5.	FACTORS OF PRODUCTION IN THE ISLAMIC ECONOMIC SYSTEM.....	92
6.	THE ISLAMIC MORAL ECONOMY AND ITS EFFECTS ON ISLAMIC FINANCIAL INDUSTRY.....	99
7.	CONCLUSION	100

CHAPTER 4. WESTERN CORPORATE GOVERNANCE THEORY: THE PROFIT MAXIMIZATION PROBLEM

1.	INTRODUCTION.....	102
2	OWNERSHIP AND CONTROL:A HISTORICAL PERSPECTIVE OF THE TWENTY FIRST CENTURY CORPORATION.....	103
3	BERLE AND MEANS AND ‘CORPORATE POWER AND CONTROL’: AN EVOLUTIONARY CORPORATE GOVERNANCE VIEW.....	109
4	CORPORATE THEORY A BRIEF INTRODUCTION.....	114
5	THE INFLUENCE OF THE NEO LIBERAL THINKING ON JUDICIAL UNDERSTANDING OF THE CORPORATION.....	119
6	THE NEO LIBERAL ASCENDANCY	121
7	AGENCY THEORY AND THE SEPARATION OF OWNERSHIP AND CONTROL.....	123
8	CONCLUSION.....	131

CHAPTER 5 BUSINESS ETHICS, CSR AND STAKEHOLDER THEORY

1. INTRODUCTION	134
2. BUSINESS ETHICS AND CSR, THE HISTORICAL CONTEXT.....	134
3. AN ETHICAL AND ‘SOCIALLY RESPONSIBLE ‘CORPORATION CRITIQUE OF THE NEO LIBERAL MODEL AND THE SUITABILITY OF THE STAKEHOLDER THEORY FOR MODERN DAY IFI’S.....	142
4. THE FAILURE OF THE ECONOMICALLY RATIONAL MAN AND THE SHATTERED ILLUSION OF NEO LIBERAL LOGIC.....	143
5. THE STAKEHOLDER THEORY AND ITS SUITABILITY FOR ISLAMIC FINANCIAL INSTITUTIONS.....	159
6. STAKEHOLDER THEORY AND ETHICS: LEGAL DUTIES VS MORAL DUTIES.....	173
7. COMMON GOOD AND STAKEHOLDER THEORY.....	180
8. CONCLUSION: BUSINESS ETHICS, THE STAKEHOLDER THEORY AND THE PURSUIT OF COMMON GOOD: PART OF THE REGULATORY CONUNDRUM FOR THE IFI’S.....	185

CHAPTER 6 MODERN DAY IFI PRACTICES AND FINANCIAL INSTRUMENTS

1. BACKGROUND	188
2. INTRODUCTION.....	189
3. THE TWO TIERED MUDARABA AND THE ISLAMIC WINDOW OPERATIONS.....	190
i. THE TWO TIERED MODEL.....	190

iii.	THE TWO WINDOW MODEL.....	192
iv.	THE ISLAMIC WINDOW OPERATION.....	194
4.	MUDARABAH.....	197
i.	THE RESTRICTED MUDARABAH.....	199
ii.	THE UNRESTRICTED MUDARABAH.....	199
iii.	CONDITION FOR A VALID MUDARABAH AND POSSIBLE GOVERNANCE ISSUES.....	200
iv.	TERMINATION OF MUDARABAH.....	204
5.	MUSHARAKAH.....	206
6.	TYPES OF MUSHARAKAH.....	208
7.	THE BASIC RULES FOR CONCLUDING A VALID MUSHARAKAH.....	211
8.	DISTRIBUTION OF PROFITS UNDER MUSHARAKAH.....	213
9.	TERMINATION OF MUSHARAKAH AND RELATED GOVERNANCE ISSUES.....	215
10.	TERMINATION OF MUSHARAKAH WITHOUT CLOSING THE BUSINESS.....	216
11.	SALE BASED CONTRACTS.....	218
12.	MURABAH AS A SALE CONTRACT: BAY AL MURABAHA.....	220
13.	INVESTMENT ACCOUNT HOLDERS (IAH)	224
14.	CONCLUSION.....	225

CHAPTER 7. SPECIFIC CORPORATE GOVERNANCE ISSUES FOR IFI'S

1.	INTRODUCTION.....	227
2.	STAKEHOLDER VIEW AND ISLAM.....	228

3. ISSUES IN IMPLEMENTING STAKEHOLDERS' VIEW IN ISLAMIC FINANCIAL INSTITUTION.....	228
4. SPECIFIC GOVERNANCE ISSUES IN ISLAMIC FINANCIAL INSTRUMENTS: A CASE STUDY OF MUDARABAH, MUSHARAKA AND MURRABAHA.....	232
5. INVESTMENT ACCOUNT HOLDERS AND THE TWO TIERED MUDARABAH.....	233
6. THE TWO TIERED MUDARABAH AND DISCLOSURE REQUIREMENTS.....	234
7. INVESTMENT ACCOUNT HOLDERS AND LEGAL OWNERSHIP ISSUES.....	236
8. INVESTMENTS ACCOUNT HOLDERS AND DEPOSIT PROTECTION: A GOVERNANCE RISK.....	238
9. INVESTMENT ACCOUNT HOLDERS AND NEGLIGENCE: THE LEGAL RISK.....	238
10. TAKING THE BOARD OF DIRECTORS ON BOARD: A POSSIBLE SOLUTION.....	239
11. A TWO TIERED BOD FOR IFIS: THE EUROPEAN CORPORATE GOVERNANCE MODEL.....	239
12. THE INVESTMENT ACCOUNT HOLDERS AND THE AGENCY PROBLEM.....	240
13. THE PROFIT EQUALISATION RESERVES AND INVESTMENT RISK RESERVES: THE CORPORATE GOVERNANCE ISSUES.....	242
14. TIME BARRED MUDABAH CONTRACTS.....	245
15. TERMINATION OF MUDARABAH AND THE MINIMUM TIME LIMIT....	247
16. AN ALTERNATIVE SOLUTION TO THE TIME BARRED MUDARABAH: THE CONTRACTUAL STIPULATIONS.....	247

17. THE POWER OF TERMINATING MUDARABAH.....	248
18. MURABAHA.....	250
19. ENFORCEMENT OF PROMISE AND CONTRACTUAL UNCERTAINTY UNDER THE MURABAHA SALE.....	251
20. CHARGING THE MARK UNDER MURABAHA: SHARIA COMPLIANT OR NOT?.....	254
21. ARBUN AND HAMISH JIDDIYA: A SHARIA GOVERNANCE CONTROVERSY?.....	255
22. MURABAHA BUY BACK AND TAWARUQ SALE.....	256
23. THE LIBOR CONTROVERSY	260
24. SHARIAH SUPERVISORY BOARDS: MOVING TOWARDS THE REGULATORY OVERSIGHT.....	261
25. THE SSB AND THE STAKEHOLDER ORIENTED MODEL: THE ROLE OF REMUNERATION FOR THE BOD.....	263
26. CONFLICTS OF INTEREST BETWEEN SSB AND EXECUTIVE MANAGEMENT.....	264
27. FATWA’S AND THE POWER OF THE SSB.....	265
28. CONCLUSION	268

CHAPTER 8: DRAWING A SYNERGY BETWEEN THEORY AND PRACTICE - A MOVE TOWARDS A MORE STAKEHOLDER- ORIENTED REGULATORY FRAMEWORK FOR MODERN IFIs.

1. INTRODUCTION.....	270
2. THE REGULATORY STATE AND THE STAKEHOLDER THEORY: LAYING THE GROUND WORK FOR THE REGULATORY FRAMEWORK FOR IFIS.....	272

3. META REGULATIONS: A NEW AVENUE FOR ISLAMIC FINANCE?	274
4. THE REGULATORY ISSUES EMANATING FROM CORPORATE GOVERNANCE THEORY AND ISLAMIC FINANCIAL THEORY.....	277
5. THE AIM OF THE REGULATORY FRAMEWORK FOR THE ISLAMIC FINANCE INDUSTRY.....	278
6. THE CURRENT REGULATORY FRAMEWORK: THE THREE APPROACHES.....	280
i. THE FIRST GROUP.....	280
ii. THE SECOND GROUP.....	283
iii. THE THIRD GROUP.....	285
7. THE REGULATORY DEBATE AND THE AIM OF ISLAMIC FINANCE: REGULATING ON PRINCIPLES.....	286
8. CONCLUSION.....	288

CHAPTER 9: RECOMMENDATIONS AND CONCLUSION

1 A GOAL AND PRINCIPLES BASED META-REGULATORY FRAMEWORK FOR ISLAMIC FINANCE.....	290
2 POLICY RECOMMENDATIONS: A MOVE TOWARDS A PRINCIPLE BASED REGULATORY FRAMEWORK.....	292
3 CONCLUSION.....	306
4 BIBLIOGRAPHY	309

Acknowledgments

I want to acknowledge all the support forwarded to me in this thesis by my Supervisor Dr Lorraine E Talbot, without whose guidance and patience this thesis would not have been possible. I also want to thank all the emotional and moral support given by my dear wife who bore through with my thesis patiently. I also want to thank my parents without whose prayers and constant encouragement this thesis would have been impossible. I would also like to thank all my PhD colleagues at the Law school how were always a source of invaluable formal as well as informal guidance and discussion. And amongst my PhD colleagues I would like to make a special mention of Dr Raza Saeed for his support and encouragement. Last but not the least I would like to dedicate this thesis to my daughter Azmeh Sheharyar, who has brought us immense joy and blessings. She is the reason I was motivated to finish this piece of work and be able to aim for higher objectives.

DECLARATION

I hereby declare that this thesis has not been submitted for any other degree.

ABSTRACT

This thesis argues that the Islamic finance industry has its ideological foundations in the business ethics and stakeholder theory since the Islamic jurisprudence supports the ethical foundation of business and financial intermediations. These ethical practices can be traced back to jurisprudential concepts of *Maqasid Al Sharia* and *Maslaha* in Islamic law. The current practices of IFI however fails to follow the ethically sound (and in line with the *Maqasid* and *Maslaha* ideals) stakeholder model because of competitive pressures from the conventional financial industry and is thus modelled more on the Neo liberal shareholder profit maximisation ideology, focusing mainly on ensuring that the shareholders and certain investments account holders get maximum returns, thereby foregoing the interest of other stakeholders. It is thus argued that due to the incompatibility of the Neo liberal ethos with the Islamic finance ideals (the *Maqasid of Financial intermediation*), the Islamic finance industry needs to focus on more stakeholder oriented practices. The major reason for the failure of the current regulatory framework for the Islamic finance industry is the lack of any compliance and enforcement mechanism to ensure that uniform sharia governance mechanisms can be applied across the jurisdictions. This it is argued can best be achieved by international principle based Meta regulatory framework focusing on the stakeholder nature of the Islamic finance involving the IFSB and the AAOIFI and giving these bodies the authority to issue certificates of sharia compliance whereby the IFI's would be required to obtain these certificates to function as 'Islamic' institutions.

Abbreviations

- a. AUDIT AND ACCOUNTING ORGANISATION FOR ISLAMIC FINANCIAL INSTITUTIONS-----AAOIFI
- b. PEACE BE UPON HIM-----PBUH
- c. ISLAMIC FINANCIAL SERVICES BOARD----- IFSB
- d. INVESTMENT ACCOUNT HOLDERS-----IAH
- e. RESTRICTED INVESTMENT ACCOUNT HOLDERS-----RIAH
- f. UNRESTRICTED INVESTMENT ACCOUNT HOLDERS-----UIAH
- g. SHARIA SUPERVISORY BOARD-----SSB

Ch. 1 INTRODUCTION

1 Introduction

The thesis argues that from a purely theoretical point of view the regulation of the Islamic financial industry, as opposed to any other kind of industry, is justified and necessary under the simple but effective pretext of the number of stakeholders involved in Islamic finance as well as the fact that Islamic finance as an industry is no longer restricted to 'Islamic countries' and has gained a more global role in the International Financial systems.¹ It is now common place amongst both finance and law/ regulation literature to argue that in any case the financial sector needs to be regulated more strictly since it is one of the main contributors of any economy, this argument is even more cogent in the case of Islamic banks taking into account the additional factor of such financial institutions having to meet religious precepts and ideals as well as function as profit making institutions for their shareholders. The Islamic concept of distributive and economic justice is what derives the basic ideals for the industry as well as the overall economic architecture,² thus showing that the whole edifice of the Islamic financial intermediation is built on the pretext of keeping the society and the community's benefit and welfare as the highest priority while generating wealth for the individual as well as society.³ Thus it is argued in this thesis that proper principle based regulation and supervision of all aspects of the

¹ C Vasile and C Maria 'Why Are Banks Special? An Approach from the Corporate Governance Perspective' (2007), Scientific Annals- ALI.Cuza University Of Iasi, Economics Series, 55-66, (Electronic Copy Available At: [Http://Ssrn.Com/Abstract=1090291](http://Ssrn.Com/Abstract=1090291), Visited 10th March 2010)

² M U Chapra *The Future Of Economics: An Islamic Perspective* (Leicester: The Islamic Foundation, 2000a)

³ Z Iqbal and A Mirakhor, *An Introduction To Islamic Finance; Theory And Practice* (Wiley Finance 2007)

Islamic financial industry will ensure that the Islamic financial institutions (IFI's) do not go through the same situation that the western commercial banks had to go through during the most financial crisis because of poor corporate governance practices which focused on blind profit maximization pursuing a neo liberal shareholder oriented corporate governance regime. With the introduction of the IFI into the main stream the question as to the role of supervision and regulation of IFI's keeping in view their (IFI's) peculiar nature has become ever more important and practically significant.

It is argued in this thesis that for any banking or financial system to be prudentially regulated and supervised the first and foremost step is the identification of the risks inherent in that system, which is why it is important to identify and eventually manage the inherent risks in IFI's for an effective supervision and regulation.⁴ In this thesis it is identified that the other major risk being faced by the Islamic finance as an industry is the sharia noncompliance risk at the Micro level(individual financial institution level) as well as the issue of acceptance of Sharia as a valid source of law at the Macro level(the regulatory level) for the Islamic financial industry. This specific issue of non-recognition of Sharia as a valid source of law for Islamic financial industry calls for a rethinking of the current regulatory framework across the Islamic financial industry. It is in this regard that it is argued that Islamic financial industry should move towards a more principled based meta regulatory framework, so that the operation of individual IFI's are made more acceptable in jurisdiction which do not accept Sharia as a valid source of law and at the same time the IFI's are allowed to follow the true letter and spirit behind Islamic finance and Islamic economics ideology.

⁴ A Salman and Dr J Amanat 'Risk Management In Islamic And Conventional Banks: A Different Analysis' (July 2009), Journal of Independent Studies and Research-MSSE, volume 7, number 2

2. Aims

The aim of this thesis is to establish the role of corporate governance theories in defining the regulatory framework for the Islamic financial institutions in order to regulate and govern IFI's as per the Ideological and axiomatic Islamic economic framework. The thesis aim to establish such an International/ cross jurisdictional regulatory framework which would cater to the dual nature of modern day IFI's by allowing the Islamic ideals to be well amalgamated with modern governance and regulatory principles. It is thus argued that since the ethos and the ideological basis of Islamic finance are entrenched into religious and moral norms as espoused by the different traditional and modern sources of Islamic teaching and law like the *Quran*, *Sunnah*, *Ijma* and *Qiyas* makes the regulatory and governance aims of Islamic financial industry unique in its nature. It is thus argued that the best conventional corporate governance theory that can form the basis for governing IFI's is the stakeholder theory because it encapsulates the essence of Islamic finance and economics by propagating a more ethical, moral and societal friendly approach and at the same time encourages a more interventionist regulatory approach by the states(or international regulatory bodies) and can in turn ensure that all risks arising from the inherent corporate governance issues in the IFI's are properly addressed and monitored.

3. Background

The need for a specific uniquely tailored regulatory regime for IFI's has been felt for some time now, but the dearth of *shariah* qualified professionals in the non-Muslim majority countries coupled with complex religious precepts that guide IFI's has made the task anything but easy. With the current economic and regulatory

atmosphere in the financial world moving towards intervention by the governments and harmonization internationally , it is about time that IFI's were brought in the main stream and regulated the same way that conventional banks are albeit with separate and specific rules and regulation tailored for the IFI's. It is in this regard that it is accepted that effective corporate governance principles aimed specifically at IFI's may be the best way to efficiently regulate the Islamic finance industry by mitigating the specific risks that arise in IFI's rather than trying to impose principles of conventional corporate governance and regulation on the very unique nature of IFI's.

Amongst other areas of substantive prohibitory rules, by rejecting interest/ usury and speculative trading as morally abhorrent the IFI's set a very high ethical and moral standard for financial intermediation at both the individual actor level as well as at a more macroeconomic level.⁵ The stakeholder model by emphasizing upon the ethical practices also highlights such traditional ethical values of Islamic finance as justice, fairness, distributive justice and morally high standard of conduct both at the individual level as well as the collective (organizational) level.⁶

One of the major reason for adopting the stakeholder model of governance in this thesis⁷ for IFIs is the fact that it brings in and accentuates the ethically sound business practices ensuring accountability, transparency, distributive justice, recourse to a larger number of remedies for all stakeholders (both legal and non-legal) and allowing for access to effective informational channels between all

⁵ S N H Naqvi, *Perspective On Morality And Human Well-Being: A Contribution To Islamic Economics*. (Leicester: The Islamic Foundation, 2003)

⁶ Z Iqbal and A Mirakhor 'Stakeholders Model Of Governance In Islamic.' *Economic System* (2004) *Islamic Economics Studies*. 11 (2), 43-63

⁷ B A Ackerman and A Alstott, *The Stakeholder Society* (Yale University press 1999)

stakeholders and is thus considered to be the best possible model for corporate governance for all IFIs.

4. Laying the Ground Work: Issues, Challenges and Solutions.

To understand Islamic banking it is imperative to know how and why the Islamic concept of finance and economics is different from the conventional financial system. As per popular belief one of the main points of difference between Islamic finance and conventional finance is the prohibition of *Riba* (interest based transactions/ usury) ,⁸ whereas this is one of the main features of the Islamic financial system it is by no means the only difference from the conventional finance. Issues of *Gharar and Mysir* (speculative transactions, contractual ambiguity and gambling)⁹ also make Islamic finance completely devoid of any swap or derivative transactions which involves speculation, thus making Islamic finance rely on its own ingenuity to come up with different financial and banking products while keeping within the precepts of the *Sharia*(the Islamic law).

Sharia law has its roots in the teachings of the *Quran* and *Sunnah* (teachings of the Prophet Mohammad). This religious feature makes Islamic Finance it unique in its nature,¹⁰ as one of the main features of *Sharia* based economic and financial rules dictates that all activities of the economic agents in an Islamic financial system are to be governed by the underlying relationship between man and God, therefore high standards of morality and ethics become an integral part of the economic system.¹¹

⁸ S N H Naqvi, *Ethics And Economics: An Islamic Synthesis* (Leicester, The Islamic Foundation 1981)

⁹ Iqbal and Mirakhor (n 3) 67

¹⁰ S Haron, *The Philosophy Of Islamic Banking* In A. Siddiqi *Anthology Of Islamic Banking* (Institute Of Islamic Banking And Insurance, London 2000a)

¹¹ Iqbal and Mirakhor (n 3) 15

In Islamic finance, moral and normative ethical principles are further translated into the concept of economic distributive justice and pursuit of social welfare for the society as a whole which can be deemed analogous to the ‘public good’ argument made in the financial regulation literature that states that regulation of financial institutions is necessary to further the public good of the society.¹² Under Islamic financial system, unlike the conventional financial system, the emphasis is more on economic justice, distribution of wealth over a wide spectrum of society and social wellbeing. Following this argument the aims of an IFI are not restricted merely to pure profit making activities¹³ but transcend into more ‘social’ goals and thus a regulatory and governance framework which can serve these ideological purposes should be put in place for IFI. It is thereby argued that trying to use the conventional en vogue neo liberal profit maximizing norms will fail the Islamic finance industry as a whole. This aspect of societal wellbeing emphasized in the Islamic finance literature can be translated to also then mean that the IFI’s should work towards the goal of a stable financial system devoid of any unnecessary crisis situations.¹⁴ It is thus argued that coupling this particular argument with the fact that the best method of corporate governance for the IFI is the stake holder method and the CSR model, means that the IFI’s need to also provide a very robust and sturdy risk management system to be in place which takes all the stakeholders into consideration.¹⁵ Thus by adapting the stakeholder and the business ethics model of corporate governance, the IFI’s cannot only maintain their own unique nature but can also prove to be exemplary financial institutions by adopting the pursuit of ‘Public good’ for the

¹² M T Usmani, *An Introduction To Islamic Finance* (Karachi, Pakistan, Idaratul Ma'arif 2000)

¹³ M Choudhury *The Foundation Of Islamic Political Economy* (London: The Macmillan Press Ltd, 1987)

¹⁴ S Qutub *Social Justice In Islam* In A. Khurshid (Ed.) *Islam Its Meaning And Message* (The Islamic Foundation, Leicester. 1980)

¹⁵ Iqbal and Markhor (n 6)

society and applying very robust Risk Management practices by keeping their emphasis on the adherence of the basic ideology of Islamic finance which also be translated into the concept of *Maqasid Sharia* and *Maslaha* as enunciated in the Islamic legal jurisprudence . It is thus also argued that the regulatory framework should be such where these aims are pursued keeping in view the Sharia aspects of Islamic finance.

Therefore in the thesis it is argued that a common ground between the *Sharia* rules pertaining to finance and the western business ethics model (as espoused by the stakeholder theory) is the abhorrence of the idea of excess profit making. Whereas Islam doesn't discourage profit making it doesn't agree with the concept of profit making at the cost of others.¹⁶ Profit is not considered the end in itself and just like in western business ethics and stakeholder theory, in Islamic finance and economics literature, profit is considered necessary to facilitate economic growth and redistribute wealth and not simply enhance individual wealth and income.¹⁷ Profit is thus considered a means to an end and not an end in itself. The stakeholder theory thus based on the ethical and moral ground provides a justification for governmental intervention in the shape of regulation and laws as a furtherance and upkeep of the normative ethical standards of a society.¹⁸ Regulation that provide the checks and balances both at the macro and micro levels for all financial institutions in general but specifically IFI should be put in place since the IFIs tend to involve a large number of stakeholders that need to be provided safeguards against any corporate misadventure and scandal and it is thus argued that the theoretical framework of the stakeholder model provides those safeguards.

¹⁶ Iqbal and Mirakhor (n 3) 19

¹⁷ F E Vogel and S L Hayes *Islamic Law and Finance, Religion, Risk And Return* (Kluwer Law International 1998)

¹⁸ R E Freeman *Strategic Management: A Stakeholder Approach* (Boston: Pitman 1984)

The stakeholder and CSR forms of governance helps the corporation in its pursuit of a Public Good for the whole society and facilitates the move away from the concept of blind profit maximization, which has been equated to greed, especially after the collapse of the financial markets across the globe. These factors surrounding the stakeholder and business ethics model of governance when looked into in detail are found to be in line with the ideology of Islamic finance and thus gives credence to the argument that in essence a regulatory framework based on stakeholder governance model and ethos is the most suitable for regulating the IFI's even in non-Muslim majority jurisdictions as well as Islamic jurisdiction so that a semblance of harmony is brought in the regulatory standards. It is acknowledged in the thesis that the current standards of corporate governance given by the two standard setting bodies IFSB (Islamic Financial Services Board) and AAOIFI (Audit and Accounting Organization for Islamic Financial Institutions) though elaborate fall short because of the lack of compliance mechanism. In order to overcome this lack of compliance mechanism it is recommended by this thesis that a Meta regulatory framework should be instituted which integrates the two standard setting bodies into the overall regulatory architecture of the Islamic financial industry with substantial powers to effect compliance as well as set effective regulatory and supervisory standards.

The reason for the IFI's being better regulated under the pretext of the pursuit of Public Good at an international Meta regulatory level is the fact that the normative Islamic financial model puts great emphasis on the ethical and moral practices¹⁹, taking into account majority of the stakeholders and including the welfare of the society as an aim that is to be achieved at both the micro and the macroeconomic

¹⁹ Vogel and Hayes (n 17)

level.²⁰ This requirement of higher ethical standards in the shape of stakeholder mode of corporate governance and CSR policy, as will be proven in this thesis, is the basic underlying requirement to implement both the pursuits of ‘Public good’ and a robust Risk Management system in any IFI at both the macro as well as micro level.

It is in view of the similarities with the business ethics model, that it falls on to the international regulatory bodies as well as the state(s) where the IFI’s are operating by means of regulation and supervision to address these issues that may arise out of the operations of IFI’s in the Non-Muslim majority jurisdictions and ensure that the pursuit of Public good and the establishment of a robust Risk Management policy as well a tailor made corporate governance system is facilitated and complied with. It is argued in this thesis that regulations in this regard play an indispensable role, especially in the globalized economy where the corporation and banks (both conventional banks and IFI’s) are no longer restricted to countries or even regions, but have transcended jurisdictional borders. In such a powerful corporate environment, regulatory positive intervention by the governments/ national regulators in cooperation with the International standard setting bodies for Islamic finance like the IFSB(Islamic Financial services Board)²¹ and the AAOIFI (audit and accounting Organization for Islamic Financial institutions)²² by mean of Meta-regulation is essential to protect the ‘Islamic’ identity of the Islamic financial Industry.

²⁰ M Choudhoury *The Foundation Of Islamic Political Economy* (London: The Macmillan Press Ltd, 1987)

²¹ [Http://Www.Ifsb.Org/](http://Www.Ifsb.Org/)

²² [Http://Www.Aaoifi.Com/](http://Www.Aaoifi.Com/)

Meta regulation is specifically well suited for Islamic financial industry because of the lack of a coherent single body in the international financial architecture to oversee the operations and working of the IFI's as an industry. This is specifically true for the function of the oversight of sharia compliance and enforcement, which in essence becomes a regulatory impracticality keeping in view the differences between regulatory frameworks across the different jurisdiction coupled with the issue of non-recognition of sharia as a valid source of law in many secular and Muslim majority jurisdictions. Thus a principal based Meta regulatory approach with emphasis on 'substance' rather than 'form' in ideological and practical terms can be best achieved through Meta regulations with focus on gauging results rather than rules.²³

It is therefore argued that the regulatory bodies in jurisdictions that allow for Sharia to be a source of law (called Islamic countries)²⁴ also need to ensure that their regulatory framework for the Islamic Financial institutions is in line with the stakeholder theory so that the essence of the Islamic teachings is comfortably amalgamated with the conventional corporate governance and regulatory practices at both the macro and the micro level. Likewise it is argued that those jurisdictions that do not accept Sharia as a source of Law(called non Islamic or secular countries) would also benefit from such an international Meta regulatory framework because by allowing the international standard setting bodies (IFSB and AAOIFI) for the Islamic financial industry to be given a more of a licensing authority for individual IFI's, these secular jurisdictions can segregate the Sharia compliance issues from

²³ Jassar Al Jassar, *Regulatory Environment and Strategic Directions In Islamic Finance* (Proceedings Of The Fifth Harvard University Forum On Islamic Finance: Islamic Finance Dynamics and Development Cambridge, Massachusetts. Center For Middle Eastern Studies, Harvard University 2000)

²⁴ Categorisation of Islamic countries and non-Islamic countries for this thesis will be done according to the acceptance of sharia as a valid source of law and *not* on the basis of majority Muslim population.

local legal and regulatory issues. In essence, rather than hoping for local national regulators to make exceptions for or draft separate regulatory standards for the IFI's, the international standard setting bodies like the IFSB and the AAOIFI become the sole arbiters of sharia compliance issues by being more of certification bodies rather than simple standard setting bodies. Thus creating a two tiered regulatory approach for the IFI's, where by the standard setting bodies for the IFI's are given a sole responsibility for the enforcement and assurance of adherence to sharia standards only by issuing certificates of compliance for those financial institutions which intend to function as IFI's. This over all Meta regulatory financial architecture will enhance the stakeholder confidence in the whole industry and will allow Islamic finance to truly reach a global audience and customer base. This is discussed in detail in the final chapter of the thesis.

Keeping in view one of the main normative standards of Islamic economic system as discussed by Asutay in his model of Islamic moral economy as well as other traditional and contemporary writers like Umar Chapra, Naqvi and Siddiqui the focus of Islamic economic seems to be primarily on economic and distributive justice. The argument is also made in this thesis that the conventional system of corporate governance with its focus on the neo liberal notion of profit maximisation has failed to achieve any social benefit and has led to systemic crisis of the financial system as well as confidence in conventional neo liberal based regulatory and corporate governance frameworks. It is therefore argued in this thesis that IFI's, basing their reliance on *Sharia* based economic and financial norms and values, should move away from such a governance and regulatory framework and move towards a more ethically sound stakeholder based governance model with special emphasis on 'substance' and 'principles' and not 'strict rules' and 'form'.

It is also established in the thesis that under the Islamic economic model, the state has the right and the duty to re-distribute property, among those who have the primary right (stakeholders), and those who have a secondary right (the society). This is in the first stead achieved by distribution of wealth in the form of *zakat* (obligatory Alms giving or Tax).²⁵ The second method of achieving the goal of distribution of wealth is through economic activity carried out by the individuals under the principles of *shariah* with a focus on fostering partnerships and ensuring that wealth is not accumulated by the few.²⁶ Thus to achieve this goal the Islamic finance literature and principles do not accept ‘loans’ as a viable and preferred method of financial activity, seeing it as merely charitable, the emphasis instead is on generating real economic activity by risk sharing and financing through partnerships.²⁷ It is therefore argued that Islamic financial institutions should be providing funds on equity or profit sharing basis and be more concerned with risk return proportion (meaning that those who take the most risk should get the most return in an economic transaction) and the real economic activity generated by that transaction than with collateral and guarantees of the borrowers as is the case in conventional banking practices.²⁸ In the normative Islamic financial system those who are not wealthy, but have worthy investment projects, may also gain appropriate access to finance by fostering partnership contracts or agency relationships that may

²⁵ T Philipp, *The Idea Of Islamic Economics*, (1990) New Series, Bd. 30, Nr. 1/4 , 117-139
Published By: BRILL Stable URL: <http://www.jstor.org/stable/1571048> Accessed: 17/09/2010 08:27

²⁶ N Siddiqui, *Partnership In Islamic Banking*(The Islamic foundation 1985)

²⁷ M Umar Farooq, *Exploitation, Profit and The Riba-Interest Reductionism*. (Paper Presented At The Annual Conference Of Eastern Economic Association (EEA), New York, February 23-26 2007b)

²⁸ T Al Diwany, *Islamic Finance: What It Is And What It Could Be* (Ist ethical trust 2010)

be entered into under the rules dictated by the *sharia*. In essence it ought to truly reward entrepreneurship.²⁹

It is thus argued that since Islamic banking is entrepreneurial and the underlying aspect of the economic system is real asset based contracts of exchange and services (like the *Mudarabah*, *Musharakah*, *salam*, *Murabaha*, *Ijara* etc) which are devoid of speculation (*gharrar* and *Mysir*) and excessive Interest (*riba*), the Islamic economic system has the ability to foster a more risk averse, morally and ethically more sound system of finance both at institutional/ Macro level as well as at the Micro/ individual level.³⁰

However as with all corporate entities, in practice the IFI's face certain corporate governance issues, like the issues related to the working of Sharia Supervisory Board (SSB), the issues related to Investments Account holders (IAHs), regulatory enforcement mechanisms, transparency, disclosure of financial information and taking into account and balancing the interests of the different stakeholders, amongst other issues.³¹ To counter these and other corporate governance issues and the ensuing risks inherent to the IFI's it is deemed necessary that a well thought out and elaborate corporate governance structure needs to be put in place across the Islamic finance industry so that the regulatory environment is stable and adapted to the ethos of Islamic teachings.³² Looking for a one size fit all corporate governance structure or regulatory environment may not be possible for all jurisdictions and schools of thought in Islamic finance industry and thus therein lies a major conundrum for the

²⁹ M U Chapra, *The Islamic Welfare State And Its Role In The Economy*, In K. Ahmed (Ed.) *Studies In Islamic Economics* (International Centre For Research In Islamic Economics, King Abdul-Aziz University, Jeddah And Islamic Foundation, Leicester 1981)

³⁰ Vogel and Hayes (n 17)

³¹ N M Suleiman, *Corporate Governance In Islamic Banks* (See <http://www.Al-Bab.Com/Arab/Econ/Nsbanks.Htm>)

³² R Wilson, *Legal, Regulatory And Governance Issues In Islamic Finance* (Edinburgh University Press, 2012)

practitioners and academics working in the Islamic finance industry, as well as policy makers and regulators. However to find some common ground and bring some uniformity in standards and practices work is being done by the two primary regulatory and standard setting bodies for the IFI's i.e IFSB and AAOAFI and other national level regulatory/standard setting bodies, but there lacks an effective enforcement mechanism at an international level for the governance standards that are being published. It is thus argued that to overcome this lack of enforcement mechanisms the best possible solution is the instituting of a Principle Based Meta Regulatory framework which should be set out by the IFSB and the AAOIFI, with specific certification powers having been granted to these bodies to instil confidence in the stakeholders.

5. Methodology

A theoretical analysis of the research question will be carried out. The research question will be answered with reference to secondary sources such as journals, books, published standards of IFSB and AAOIFI and the writings of academic writers as well as primary sources like the *Quranic* decrees original writings of traditional *Fuqaha*(jurists) belonging to the different schools of Islamic thought as well as established *Sunnahs and Hadiths* of the Prophet Mohammad. The thesis will also draw upon the works of different academic writers in the fields of Agency theory, Corporate Social responsibility (CSR), Stakeholder theory and Business Ethics. The thesis will further look at the different theoretical and practical issues in Islamic Finance and how these apply to modern day IFI's by taking examples from regulatory regimes already in place in different jurisdictions. In the end it will look at the different theories justifying regulation in financial institutions in general and IFI's in particular and while using those theories policy recommendations are given

for a more harmonised international regulatory framework for the Islamic finance industry.

An empirical study will not be undertaken since the research question requires only a theoretical analysis of the already established works by writers in fields of corporate governance, stakeholder theory, business ethics and Islamic finance.

6. The Theoretical framework.

The thesis uses the shareholder primacy theory or the Anglo-US model(as espoused by Berle and Means ³³and later developed by several other writers) as the main substantive theory to gauge all other theories against, predominantly because of its extensive use in the two major developed financial and commercial jurisdictions i.e. the US and the UK and its influence on the intellectual development in the area of corporate governance and management theory over the last ninety years across the globe. On the other end of the spectrum Islamic finance literature which is derived from the different sources of Islamic jurisprudence (sources like the provisions provided in the *Quran*, the *Hadith* , writings of traditional and contemporary scholars) is used to draw out basic underlying principles and norms that may both form the basis of a coherent corporate governance theory that can be applied to modern day IFI's and at the same time lays down the axiomatic framework of Islamic economics and business ethos, which ought to form the basis of guiding rules and principles for the modern day Islamic financial industry.

³³ A A Berle Jr and G C Means *The Modern Corporation And Private Property* (New York: Macmillan1932)

The Islamic finance literature and theories relating to commerce/finance are then pitted against the shareholder or the Anglo-American model of governance and a deduction is drawn relying on the available literature of both Islamic finance and conventional corporate governance as to whether it is possible to draw some parallels between the two different sets of theories or not. The thesis recognizes the fact that following the Anglo-US model with its emphasis on profit maximizing goals leads the IFI's to lose their actual essence of a morally and ethically sound financial system and at the same time highlights the corporate governance problems endemic to the IFI's because of following the Anglo-US model of Corporate Governance. The thesis then moves on to compare the alternate Corporate Governance models like the Stakeholder model, the CSR literature and the business ethics literature and draws parallels with the normative Islamic finance model. The parallels between the stakeholder theory, conventional business ethics and normative Islamic finance theory are then used to form a coherent and practical corporate governance and regulatory theory for the Islamic finance industry which is deemed to encapsulate the essence of *Sharia* teachings as well as be acceptable to both *sharia* based and non-*sharia* based jurisdictions.

This assertion is based on the simple premise given in all of Islamic finance, economic and commercial literature emphasising that the Islamic financial agents(whether banks or persons) are to operate according to the principles of ; distributive justice, socio-economic welfare, ethical business practices, truth, honesty, transparency, fair dealings, holding the economic agent(and its components in case of a company or a bank) responsible for contribution to the economic growth of other stakeholders via long term and sustainable growth taking into account factors like the environment and other stakeholders like employees, customers, the

Government regulatory body etc and ensuring that no one is made economically better off at the cost of someone else irrespective of the activity being undertaking whether halal or haram.³⁴ All of these conditions and characterise help in devising a regulatory framework which is deemed the most suitable for the modern day IFI's.

The thesis is divided in the following chapters:

In the second chapter we identify the main sources of Islamic law, being the *Quran*, the *Hadith* (the saying and doings of Prophet Muhammad), *Ijma* (consensus) and *Qiyas* (analogous reasoning) and how that differentiates the Islamic financial system from the conventional legal systems. We also discuss the essence of Islamic contract law as being the basis of modern day Islamic financial intermediation and financial product development as carried out by IFI's.

In the third chapter we look at the main ideological principles of Islamic finance derived from contemporary and traditional writing focusing mainly on the ethical aspects of economic and financial activity. This chapter will focus mainly on the ethical and axiomatic aspects of Islamic finance and economic framework, in doing so the chapters lays down the main principles of the Islamic business and economic system that colours Islamic finance literature and practice and should form a main component of the normative regulatory framework for the Islamic finance industry.

In the fourth chapter we will look at the most commonly used corporate governance theory in the Anglo-American corporate and finance literature i.e the Agency or the shareholder theory and its short comings and the effect that the Neo liberal political discourse has had on modern day Corporate Governance and how that fails to satisfy

³⁴ M A Afzalur-Rahman, *Economic Doctrines Of Islam* (Islamic Publication, Lahore 1974)

the needs of a financial regulatory and governance framework based on Islamic principles, which will lay down the main theme of the thesis.

In the fifth chapter we will look at how the conventional western Business ethics and CSR theories as embraced by the stakeholder theory is compatible with the normative and the practical aspects of IFI's and should form the basis of a governance and regulatory framework for modern day IFI's as a perfect alternative to the en vogue Neo Liberal Anglo US corporate governance model.

In the sixth and the seventh chapter we look at the different financial instruments being used by modern day IFI's and the resulting governance and regulatory issues emanating from their use from a sharia as well as a conventional point of view. The chapter will include the point of views of the different schools of thought as well as contemporary literature in Islamic Jurisprudence (*Fiqh*) regarding the acceptability of these instruments and the different terms and conditions that the different schools accept as valid.

In the last two chapters, we argue for a regulatory framework for IFI's based on the stakeholder and CSR model, which can be customised for the IFI as an industry only by moving away from a rule based framework and adopting a principle based Meta regulatory framework. The principles which must be focused must be the stakeholder approach and the normative ethical standards as espoused by the Islamic finance literature. The main point for devising such a framework is the cooperation between the national regulators and the standard setting bodies of Islamic finance IFSB and AAOIFI, where by two tiered regulatory regime is put in place for IFI's that are operating in jurisdictions where sharia is not accepted as a source of law. It is argued that the responsibilities of the standard setting bodies should be enhanced

to be more on the lines of a licensing authority issuing sharia compliance certificates for IFI's wishing to work as sharia compliant financial institutions. These certificates of compliance should be considered as a separate mandatory requirement for IFI from the national regulatory requirements. It is thus strongly argued that a new level of cooperation between national regulators and the IFSB and AAOIFI should be developed and enforced if such a scheme has to work.

It is thus argued that a move from a neo liberal profit maximising ethos to a stakeholder oriented approach is deemed the best way to achieve governance and regulatory uniformity as well as ensure that Islamic finance industry supports both social, ethical and economic achievement- providing the citizens, the depositors, the investors and other stakeholders who are directly and indirectly involved with the protection and confidence they need to feel safe when dealing with the Islamic finance industry as being well structured, safe secure, sharia complaint, well governed and risk averse.

7. Conclusion

Thus it is argued that the stakeholder theory and the CSR concept, by allowing and justifying governmental (or international) regulatory intervention in the shape of not only black letter laws and regulations but also by providing such principles and norms which are in line with the axiomatic Islamic economic principles can be deemed to be the best governance models for Islamic finance as an industry. These principles in turn provide a viable option for the supervision and regulation both at the macro and micro levels for the Islamic financial industry in the shape of a Principle based result oriented Meta regulatory framework. At the same time the practice of following a stakeholder and CSR oriented approach brings the principles

and practices of Islamic finance in line with international practices and can therefore easily form the blue prints for a separate regulatory regime for the regulation and supervision of IFI's. By making CSR and the stakeholder theory as the basis of an international regulatory regime for IFI's it is ensured that the regime that is drafted for IFI's takes into consideration the multifarious unique aspects of Islamic finance and remains within the precepts of Sharia and the Islamic economic model.

CHAPTER. 2 AN INTRODUCTION TO ISLAMIC SOURCES OF LAW AND THE SCHOOLS OF THOUGHT AND THEIR RELEVANCE TO MODERN DAY ISLAMIC FINANCE

1 Introduction

To better understand the theoretical aspects of Islamic finance it is imperative to understand how Islamic law in general is practiced and what the major sources of Islamic law are, specifically those relating to Islamic finance. In the same stead the understanding of Islamic law pertaining to finance will help decipher one of the major characteristics of Islamic finance, being its divine nature as derived from the various sources of Islamic law. The other purpose of this chapter is to emphasis on the role that the perception regarding the divinity of the sources of Islamic finance have on the adherents to Islamic finance specifically Muslims and how that perception gives legitimacy to cannons of Islamic finance for Muslims wanting to practice Islamic finance not only as an alternative to conventional finance but as a religious duty. An additional purpose of this chapter is to also introduce the concept of *Maqasid Sharia and Masalaha* as representing the practical and legal embodiment of modern day Sharia and the role that these two legal concepts can play in the overall architecture of contemporary Islamic finance.

This introduction to Sharia as a legal concepts is deemed necessary to discuss because it has to be understood that at the heart of the Islamic finance industry lies the pretext that the alternative available in the financial industry is the interest based banking system which is not only riskier in financial and economic terms, giving rise to ethical and corporate governance issues, but is considered ‘*haram* (illegitimate)’ by the Muslims. By focusing on the sources of Islamic law (and thus the genesis of Islamic finance) it can be established that the ideology behind Islamic finance merits

the use of a governance and regulatory framework which is specifically tailored for Islamic finance and caters for the ethical and moral principles as laid down in the Islamic literature related to finance and economic activity and is in line with the legal doctrine of *Maqasid Sharia and Maslaha*. The importance of Sharia compatibility forms the backbone of today's contemporary Islamic finance industry and thus sharia itself has to be defined and deciphered in order to make a logical connection with the way today's Islamic financial industry is operating internationally and the way sharia is viewed as being the source of law for Islamic financial industry.³⁵

2. Sharia and its meaning

For a Muslim his/ her life is dictated by the Islamic religious law called The Sharia. The word Sharia literary means 'the path that leads to the spring'.³⁶ Figuratively, it means 'a clear path to be followed and observed'.³⁷ On the other hand Islamic law is also sometimes called '*Fiqh*', the confusion stems from the fact that while translating from Arabic to English both '*Sharia*' and '*Fiqh*' are bundled into one category for convenience. However if looked at from a pure legal terminology, *Fiqh* refers 'to the science of deducing Islamic laws from evidence found in the sources of Islamic law'.³⁸ In essence for an easier understanding of the generic term 'Islamic law' in a more western civil law and common law context, *Sharia* refers to the sum total of Islamic laws which were revealed to the Prophet Muhammad and which are

³⁵ D Abdelkader, 'Modernity 'The Principles Of Public Welfare (Maslaha) And The End Goals Of Shari'a (Maqasid) In Muslim Legal Thought' (2003) *Islam And Christian-Muslim Relations*. 14 (2) 163-174

³⁶ Dr L A K Niazi, *Islamic Jurisprudence Including Muslim Personal Law* (Niaz Jhangir Printers, Lahore, Pakistan 2009)

³⁷ H M. Ramadan (Ed), *Understanding Islamic Law: From Classical To Contemporary,* (Lanham, Md And New York: Altamira Press, 2006)

³⁸ Dr A A B Philips, *The Evolution Of Fiqh (Islamic Law And The Madh-Habs)* (International Islamic Publishing House, 2006)

recorded in the Quran as well as deducible from the prophet's divinely guided life style (called the *Sunna*).³⁹ So in essence the laws of Sharia are general in nature and lay down basic principles, *Fiqh* on the other hand is more specific and demonstrates how these principles are to be applied in given situations.⁴⁰ For this thesis we will be referring to the more general *Sharia* as embodying Islamic law and the defining principles of *Maqasad Shariah*, unless specified otherwise. Thus it can be construed that Islamic religious law springs from various sources namely the *Quran* and the *Sunnah* of the Prophet Mohammad (PBUH) in the form of *Hadith* which are categorized as the primary sources, whereas *Ijma* and *Qiyas* along with the Jurisprudence developed by the different Schools of thought can be categorized as the secondary sources.⁴¹

3. Primary and Secondary sources of Islamic law

As has been already mentioned that when one talks about "Islamic law", it has to be noted that this is somewhat an ambiguous term since it combines two Arabic terms, *Shari'ah* (divine law) and *fiqh* (human comprehension of that law). The distinction between *Shariah* and *Fiqh* is an important one since the difference basically lays down the ground work for any development of modern day Islamic laws regarding any aspect of the Islamic life.⁴²

In the first instance, since the Muslims hold the view that God is the true and only law-giver, any legal position must ultimately be derived from the *Quran* which Muslims believe, was revealed to the Prophet Muhammad, also called the Messenger of God, by the angel *Jibril* (Gabriel) and thus any edict present in the

³⁹ Bilal 17

⁴⁰ M H Kamali, *Shari'ah Law: An Introduction* (One world Publications, Oxford. 2008)

⁴¹ M. H Karnali, *Maqasid Al-Shari'ah: The Objectives Of Islamic Law* (Islamic Research Institute, International Islamic University Islamabad. Islamabad 1999)

⁴² Bilal (n 38) 18

Quran can neither be denied or amended and is the ultimate authority for any aspect of a Muslims life.⁴³ However the matter of interpretation of the Quran's edicts is a contentious issue and is left to the Jurists who are deemed to be the experts in that area. The role of the jurists and sharia scholars is one of the major characteristics of the modern day IFI, since these religious scholars and jurists form the sharia supervisory board of individual IFI's as well as contribute greatly to the regulatory standard setting bodies like the IFSB and AAOIFI, whereby they act to ensure that all IFI's work within the ambit of *sharia*.

The second one is the *Sunna*,⁴⁴ that is, the deeds, utterances and tacit approvals of the Prophet Muhammad, as related in the *al-hadith* or traditions (the singular hadith is also used for tradition in general),⁴⁵ handed down through a dependable chain of transmitters. Sometimes, the term *Sunna* is used in a wider sense, including the deeds of Prophet Muhammad's companions and successors. In essence however *Sunna* is understood to be the revelation of His (God's) divine will transmitted through the prophet Muhammad.⁴⁶

The *Quran* and the *Sunna* are the primary sources. They are taken by Muslims as representing the actual word and the will of God and thus rank in priority to the

⁴³ I A K Nyazee, *Islamic Jurisprudence (Usul Al-Fiqh)* (Islamic Research Institute Press Islamabad, 2000)

⁴⁴ **Sunnah:** the way of the Prophet Muhammad taught by him verbally or practically. 'Islamic Economics And Finance: A Glossary 2nd Edition Muhammad Akram Khan, 174, Published In The USA And Canada By Routledge 29 West 35th Street, New York, NY 10001.

⁴⁵ **Al-Hadwth** (Pl. *Al-Ahadwth*) speech, action, habits and events of the prophet's life codified by his companions and enlarged and revised by later Muslims. There is a large collection of *ahadwth*, the most authentic of which have been recorded in the six books compiled by bukhari, muslim, tirmadhw, abw dawwd, ibn majah and nisa'w. These books are known as *sihah sittah*, the 'six correct compilations'. There are other collections also, the compilers of which are not regarded with comparable grace. In the process of collection and compilation of *ahad wth*, a detailed art of evaluation was developed. Later on all *ahadwth* were graded according to the criteria accepted by the majority. The *hadwth* is second source of law in islam. In islamic economics as well, the contents of authentic *ahadwth* are accepted as a valid primary source'. Ibid Muhammad Akram Khan 69

⁴⁶ M A Afzalur-Rahman, *Muhammad: 'Encyclopedia of Seerah,'* (Vol.2. The Muslim School Trust, London1982)

other sources of law.⁴⁷ Even though having acknowledged these sources as the divine will and the authentic source(s) of Islamic law pertaining to almost all the aspects of life, the modern day Muslims still face a conundrum of what to do with problems that have not been either addressed at all or incompletely addressed in the *Quran* and the *Sunna* .

In order to supplement such gaps the jurisprudence established to give authority to the *Hadith* has been developed by the different schools of thought and jurists over the period of time, with elaborate checks and balances ensured in the system of authentication to derive the validity of such *Hadith* which can actually be attributed to the words, actions and habits of the Prophet Muhammad.⁴⁸ This is an important aspect for the Islamic Finance industry as most of the earliest jurisprudence developed regarding Islamic finance has been done through the reliance on *Hadith* with further developments through the use of *Qiyas* (analogous reasoning) and *Ijma* (consensus).⁴⁹

However even the reliance on *Hadith* as such do not cover all aspects of modern day finance and trade and the other complex corporate issues for Muslims like issues of the Limited liability of the modern day corporation, corporate governance, intellectual property and the permissibility of many of the trade practices and complex financial instruments involved in modern day Islamic finance. Another problem that has always been an concern for Muslim thinkers and intellectual, both modern and traditional, is the fact that the *Quran* and the *Sunna* leave room for different interpretations, giving rise to the risk of subjectivity in the interpretation by individual jurists and scholars thereby raising concern for the implementation of rules pertaining to the different aspects of an injunction as expounded in the *Quran*

⁴⁷ Nyazee (n 43)

⁴⁸ J Schact, *An Introduction To Islamic Law*. (Oxford, The Clarendon Press 1964)

⁴⁹ Afzalur-Rahman (n 46)

and the *Sunna*. This issue of subjectivity can systemically diminish the effectiveness of the religious injunctions since the differences are not necessarily restricted to the individuals but also transcend the different schools of thought across the Muslim *Ummah*.⁵⁰ To counter this problem of subjectivity, the Muslim *Ummah*(*Ummah* meaning a society based on religious affinity) as a whole has the option to resort to secondary sources to further clarify and elaborate upon any issues of concern that are not clear in the primary sources.⁵¹

So to give these primary sources a practical manifestation and to adapt these primary sources to the everyday situations(including those novel and unique situations which have not been discussed in detail in the *Quran and Sunna*), the responsibility is transferred to those individuals who have the requisite skills in interpreting the revealed sources, namely qualified religious scholars or *ulama*.

4. Fatwas; an introductions

In case of where there is a confusion or where the issue at hand is unclear the Muslim as an individual or as a body (legislative body, as a court or any other legal body like a bank or company) can ask for expert opinions from the religious legal scholars called *Mufti(s)* or '*Ulama*' who are experts in *Fiqh*, these *Ulama* in turn give their decisions in the shape of legal opinion based on the principles of sharia. This legal opinion is called the '*fatwa*' and these form an indispensable source of modern day Islamic law in general and is probably one of the most important characteristics of modern day Islamic finance.⁵² In modern day IFI's these fatwas are delivered by means of a sharia supervisory board (SSB), which is responsible for

⁵⁰ Niazi (n 36) 35

⁵¹ Ghamidi, *Islam: A Comprehensive Introduction* (Al-Mawrid Publishers, Lahore, Pakistan. 1st Ed, 2010)

⁵² Ghamidi (n 51)

the sharia compliance of the IFI operations and activities. From both a corporate governance and regulatory point of view, the working and the regulation of SSB activities is of prime importance for the IFI's as an industry, something which will be discussed in chapter 5, 6 and 7.

5. Islamic law schools and their legal and socio-economic effects on modern day Islamic finance.

Another very important aspect of Islamic law is the presence of the major schools of thought or *madhabs* amongst the Muslim community.⁵³ This division of the schools of thought tends to determine many of the important questions and their answers as these schools of thought tend to agree on only certain aspects of the Islamic law and tend to be in divergence with each other in the certain other aspects of the applications of the sharia principles. This division of opinion giving rise to many complications when applying and interpreting a particular principle of Islamic law which in turn erodes the aspect of uniformity in Islamic law.

From the point of view of the Islamic finance industry, this is a very important aspect of *sharia* that it allows for the practitioners, regulators, customers and other stakeholders to carry out what is called sharia forum shopping.⁵⁴ As a caveat it must be mentioned that only a brief introduction will be given to these schools of thought and that too only from the point of view of Islamic financial industry here since it is not possible to discuss all the intricacies of the jurisprudential difference and similarities of all these schools of thought in this thesis in any great detail.

⁵³ M N Siddiqi (n 26)

⁵⁴ S M Ahmed, *Economics Of Islam* in S M Ahmed, *Social Justice In Islam*, (Institute Of Islamic Culture Lahore 1975)

The ability of Islam in general and Islamic law in specific to adapt according to the need and requirements of changing times are to be further looked at through the prism of the different schools(*madhabs*) recognized by both traditional and contemporary Islamic scholars.⁵⁵ This ability to adapt is both beneficial and necessary for Islamic law and its adherents. One major aspect of the Islamic jurisprudence is the presence of these schools of juristic thought, which have interpreted and adapted different facets of *sharia* as and when the requirement arose relying on both the primary as well as secondary sources of Islamic law.⁵⁶

This is not to say that there have been no problems with this particular aspect of Islamic jurisprudence, specifically pertaining to the issue of lack of uniformity at many places and in some instances giving rise to some very serious disagreements between the schools of thought.⁵⁷ This particular issue is further exasperated by the fact that Muslims no longer necessarily live in Muslim majority countries and thus may not have central religious authorities that may provide any kind of oversight of such a function being carried out by these scholars. Therefor giving rise to the very likely possibility that even where Muslims are in the majority in one jurisdiction there may be adherents of different schools of thought living and using ‘their’ own version of a particular school to decide upon a particular issue. However these instances can be curtailed significantly by dialogue and by using *Ijma* and *Qiyas* amongst the scholars of the different schools of thought, which may give rise to a very rich and detailed culture of debate and agreement on most of the pressing issues facing Islam in general. This is specifically a major ongoing academic and practical

⁵⁵ S M H Zaman, *Economic Functions of An Islamic State: The Early Experience*. (The Islamic Foundation, Leicester 1991)

⁵⁶ M A Afzalur-Rahman, *Islam Ideology And The Way Of Life* (The Muslim School Trust, London 1980)

⁵⁷ M O Farooq, *Toward Our Reformation: From Legalism to Value-Oriented Islamic Law and Jurisprudence*. (Herndon, Virginia: International Institute Of Islamic Thought 2008b)

issue for the Islamic finance industry across the globe specially because the Islamic finance industry has not yet overcome (or mostly overcome) internal disagreements about how to interpret different aspects of jurisprudential and practical issues relating to Islamic finance and have yet to unite to face challenges posed by these differences.

Even though the Islamic jurisprudence laid down by the different scholars (belonging to different schools of thought) is an important source of modern day Islamic law, it has to be kept in context of what has already been mentioned, that a distinction has to be drawn between the two sources of Islamic law i.e the *sharia* and the *Fiqh*. For Muslims the *sharia* is the actual source of Islamic law comprising of the *Quran* and the *Sunna* of the Prophet Muhammad and is thus immutable and accepted by Muslims as such, there is no room (or very little room) for any interpretation what so ever,⁵⁸ however on the other hand, the Islamic *Fiqh* or Islamic Jurisprudence which is derived from the different schools of thought is open to both interpretation and to an extent criticism as it is in essence only a juristic opinion by a renowned scholar(s) of their times. So the sources and thus the effects thereof of these sources are to be categorized accordingly in that hierarchy.⁵⁹

According to Hans Visser⁶⁰ there are thus four major schools of law belonging to the contemporary *Sunni Madhab*. These schools of thought are usually of differing opinions regarding some of the subjects but more often than not they are in mutual agreement on certain basic principles of the subjects. The four *Sunni madhahib* are the *Hanafi, Maliki, Shafii and Hanbali Schools*.

⁵⁸ M A Haneef Islam, *The Islamic Worldview, And Islamic Economics* (1997) HUM Journal of Economics and Management. 5 (1) 39-65

⁵⁹ Philips (n 38)

⁶⁰ H Visser , *Islamic Finance: Principles And Practice* (Edward Elgar Pub 2009)

The relevance of these schools of thought and the difference and the similarities therein are important even today since some countries follow exclusively one school where as other countries have adherents of more than one school inside their borders. From the point of view of the current situation in the Islamic financial industry these differences can mean the categorizing of permissible (*Halal*) and non-permissible (*Haram* or illegitimate) modes of finance. Thus there is an ongoing debate regarding this particular issue of compatibility of religious findings and rulings (called *Fatwas*) amongst the scholars, academics, regulators and practitioners of Islamic finance.⁶¹ It is therefore argued that if the importance of these differences is not comprehended and taken into account the whole Islamic finance industry is at the risk of collapsing because if there is no uniformity and unanimity regarding the permissibility of certain financial instruments amongst the different countries of the Islamic world (and even countries which are not populated by a Muslim majority) there can be no regulatory developments and no international trade, commerce or financial activity can flourish in this atmosphere of uncertainty. This lack of certainty is believed to be one of the major challenges of the modern day Islamic finance industry globally and poses a unique kind of risk in financial regulatory terms called *Shariah* governance risk and reputational risk.⁶²

6. The basis of Islamic financial instruments: A short introduction to Islamic contract law

There are three main pillars of modern day Islamic finance, the prohibition on *Riba* (Usury) being the most renowned one, the second is the Prohibition of *Gharar and Mysir* (speculations and Gambling) and the third one being the law of Islamic

⁶¹ K Ahmad, '*Islamic Finance and Banking: The Challenge and Prospects.*' (2000) Review Of Islamic Economics. 9, 57-82

⁶² Ibid Ahmad 9

contracts, which has some unique feature that determine the validity of modern day Islamic financial instruments. Besides the two pronged prohibitions on *Riba and Gharar*, the law of contract in Islamic teaching has a unique feature that needs to be understood in the context of the Islamic business practices. There are two different schools of thought on the permissibility of the kinds of contracts that can be used under Islamic law. The more traditional explanation for the law of contract is that the forms of the contract that were historically accepted by the Prophet Muhammad and his followers are the only kinds of contract that are permissible, their terms may be varied slightly remaining within the boundary of the original form.⁶³ On the other hand the more flexible theory, also derived from the *Quran* itself is that all contracts are basically allowed as long as they have not been specially banned by either the *Quran, hadith or Ijma*(consensus) and *Qiyas*(analogical reasoning).⁶⁴ So in essence anything not specifically banned is allowed.⁶⁵ Ultimately all financial instruments and legal vehicles that have been or normatively can be used to develop any financial product have to be compliant with sharia principles and have to be carried out according to the principles of the law of contract in Islamic law.⁶⁶ It is in that light that it has to be understood that unlike western law of contract, Islamic law of contract is not considered to have a general theory of contract.⁶⁷

Vogel and Hayes and other contemporary writers have concluded that the Islamic law of contract does not have any specific legal theory that can be applied to the law

⁶³ N C Obeid, *The Law Of Business Contracts In The Arab Middle East* (1996)

⁶⁴ O Arabi, *Contract Stipulations (Shurut) In Islamic Law: The Ottoman Majalla And Ibn Taymiyya* (1998)

⁶⁵ Y Musa 'Liberty of The Individual in Contracts and Conditions according To Islamic Law.' (1955), *Arab Law Quarterly* V II, 83

⁶⁶ M E Hamid, 'Islamic Law of Contract or Contracts,' *Journal of Islamic and Comparative Law*. 3:1-11

⁶⁷ N Mohammed , 'Principles Of Islamic Contract Law' (1988) *Journal Of Law And Religion* Vol. 6, No. 1, 115-130

of contract,⁶⁸ instead the rules and principles of Islamic law of contract are derived from very specific archaic forms of contract that have been derived from the main sources of Islamic law and customary trade practices of Arabia which were carried out during the times of Prophet Muhammad who endorsed those practices by oral words or by practicing them himself and these laws and rules of contract have been translated into specific nominate contracts.⁶⁹ Even though the more traditionalist Islamic scholars argue that no new contracts can actually be initiated or accepted because the only acceptable contracts were the ones that were in practice during the time of Prophet Muhammad, however the more contemporary writers refer back to the basic provision about the law of contract in Islamic law that if a contract is not going against any of the substantive prohibitions of the *Quran* and the *hadith*, a new contract can be allowed.⁷⁰

The main underlying theme of these nominate contract has been their historical religious roots which have made these nominate contract rigid in their form since the development of the trade in Arabia at the time of the advent of Islam was regulated by these contracts and since these nominate contracts were substantial in covering the basic trade in those times and subsequent time till the late twentieth century, these contracts have remained static and have gained a very specific form rarely being changed or disagreed upon even by the different schools of thought.⁷¹ This particular context of the foregoing historical development of the law of contract in sharia has the modern Islamic finance industry on the whole facing a conundrum as to how to handle new financial and legal issues that have cropped up with the ever changing spectrum of business and finance on the whole.

⁶⁸ Vogel, Hayes and Frank (n 17)

⁶⁹ Ibid Vogel, Frank 97

⁷⁰ M A A Sarker, 'Islamic Business Contracts, Agency Problem and The Theory Of The Islamic Firm,' (1999). International Journal of Islamic Financial Services, 1 (2)

⁷¹ Arabi (n 64)

The other very important aspect of the Islamic law of contract that has been argued by scholars is that the concept of the freedom of contract as understood by western legal scholars is significantly curtailed under Islamic law, as the will of the parties is restricted to those particular events that pertain to the entering into the specific or nominates contract types. Even though the contract may have been concluded by the parties the effect of the contract is not what the parties would have agreed upon or intended, rather the effect(s) of the contract will be what the *sharia* determines.⁷² The aim of this particular restriction is the protection of weak parties against injustice and exploitation.⁷³ This is different than the western law of contract where offer, acceptance, intention to create legal relations and consideration constitute a valid contract as long as the objective of the contract is not illegal under that particular jurisdiction's law. In Islamic law of contract the objective of the contract remains the most important aspect, over shadowing the freedom of the contract of the parties.⁷⁴ If the objective is one that is recognised by the rules, principles and laws governing sharia the contract will be valid and enforceable but if not the whole contract may be held void or if it is deemed that only one or more term is against the basic principle of *sharia* and the Islamic ethics of justice and equality that term may be removed to make the rest of the contract valid even if that term is a substantive aspect of the contract.⁷⁵ In essence then the normative rules of Islamic law governing contracts requires the substance as well as the form to be complaint with the basic principles of sharia, specifically governing the commercial and business law(called

⁷² Obeid (n 63) 5

⁷³ M H Karnali, *Maqasid Al-Shari'ah: The Objectives Of Islamic Law.* (Islamic Research Institute, International Islamic University Islamabad 1999)

⁷⁴ Diwany (n 28)

⁷⁵ Ibid Diwany

Fiqh Muammalat) and ethics.⁷⁶ The Islamic law of contract can thus be analysed under two different heads, first: The term of the contract (*shurruṭ*) and second: The object of the contract.

i. Innominate contracts and stipulations (*shurruṭ*)

The different type of nominate contracts that the *fuqaha* (jurists) developed are the contract for sale (*bay*), partnership (*musharaka* / *mudaraba*), hire (*ijara*) and pledge (*rahn*).⁷⁷ Traditionally the sale contract was recognised as the basic form of a valid business contract and it was on the basis of this sale contract that the traditional jurists and writers developed a body of the other contracts like partnerships, hire and pledge. The sale contract is primarily important because it allows a certain amount of freedom of contract in trade with some flexibility sketched in its substance and form. It is for this reason it is frequently said by scholars that there is no law of contract in Islamic jurisprudence rather there is a law of ‘*contracts*’.⁷⁸ It is primarily for this reason that even today Islamic banking products are formulated on the basis of sale of assets and some forms of partnerships and it is thus argued that partnerships and real asset based transactions ought to form the majority of Islamic financial transactions, however that is not the case. It is this divergence from the basic forms of economic activity dictated by Islamic economic and commercial principles that raises the fear of possible systemic failure of the whole Islamic finance industry.

Despite the effort of early Muslim scholars to develop a body of contracts that could cater for most of the needs of the time, the mechanisms could only be engineered

⁷⁶ M H Kamali, *Islamic Commercial Law: An Analysis Of Futures And Options* Islamic (Texts Society, Cambridge, UK 2000)

⁷⁷ All of these contracts will be discussed in more detail in the next chapters.

⁷⁸ Hamid (n 66) 11

within the frame work of the existing pre Islamic practices and that led to a prolonged period of reliance on old forms and stagnated any growth and development of this body of law.⁷⁹ Some developments have since then taken place and the Islamic law of contract is now better suited to financial and legal engineering to adapt to modern times due to work done in this area over the last couple of decades, but at the heart remains the basic fundamental ethos of Islamic finance: ban on *Riba*, ban on excessive speculation, ban on gambling, ban on exploitation, equality of bargaining positions, justice, honesty and an overarching requirement whereby any contracts that are in clear violation of Islamic injunctions can never be validated.⁸⁰

The major reason for restricting the parties 'will' in a contract is the aim of ethical control of Islamic law to prevent injustice and exploitation of parties. It is believed by scholars that the wisdom behind this control over the parties 'will' is so that the parties may not enter into contract that may circumvent any of the prohibitions categorically mentioned in the *Shariah*.⁸¹

The different schools take different positions in this regards too, with some schools allowing for the alteration of certain terms and other disallowing them. The major area of difference in the point of views of the different schools of thought regarding the law of contract under *Sharia* is the distinction between what Tarek al diwany calls 'cornerstones' (*Rukn*) of the contract, things which are indispensable and essential for the existence of the contract or in other words the absence of which the contract cannot exist and 'conditions' (*shurut*) which are over laid over the

⁷⁹ Hamid (n 66) 10

⁸⁰ H Hassan 'Contracts Of Islamic Law: The Principles Of Commutative Justice And Liberality' (2002) *Journal Of Islamic Studies*, 261

⁸¹ Obeid (n 63) 32

cornerstones.⁸² All the juristic schools of thought assert that the relationship between the cornerstones and conditions is symbiotic in the sense that if the cornerstones are present a valid contract can be concluded. However the schools are divided on the relevance of the ‘conditions (*shurut*)’ in a contract. The *hanafites* believe that if in a properly concluded contract a condition which is prohibited is entered into, the contract becomes defective(*fasid*) but not void, however the other schools of thought believe that such a condition would render the contract as void(*batil*).⁸³

There is also some difference between the schools of thought as to what conditions(*shurut*) are actually allowed in a contract and also as to how flexible are the nominate contracts in altering such conditions. The strictest position regarding the alteration of terms of the contract under Islamic law is taken by the now much less relevant school of thought the *Zahirites* who believe that all contracts and conditions not expressly allowed by the *shari’a* through the *Quran*, *Sunna* and *Ijma* (consensus of opinion) are prohibited.⁸⁴ Their strict application refers not only to the contracts themselves, meaning that not only do they not accept any new contracts other than the ones already established under *shariah*, they also refuse any alteration in the set terms(called *Shurut* or conditions) of these contracts. The basis for this extreme position of the *Zahirites* is found in the *hadith* (saying) of the Prophet: “he who has done an act which we have not ordered him to do, his act is null and void.” and a second *hadith*: “What then do you think of men who stipulate conditions that are not in the Book of God. Whatever condition there be which is not in the Book of God is void, be it a hundred conditions.”⁸⁵

⁸² Diwani (n 28) 92

⁸³ Diwani (n 28) 93

⁸⁴ Obeid (n 63)

⁸⁵ Musa (n 65) 83

The *Hanafite* scholars take a slightly more lenient stance; they divide *shurut* into three categories. The first category consists of those conditions which are inherent in the nature of the contract⁸⁶ add nothing new to the contract but only confirm effects that the contract has under the *shari'a* (*shart yaqtadih al aqd*).⁸⁷ Or in simpler terms these are the most obvious of the terms in the contract which may or may not be present in the contract, for example the stipulation that upon changing of possession of a good in a concluded contract the title would change hands too (assuming the sale has been concluded and the reason of the sale was to change possession of the said goods). The second category is of conditions that are suitable to that contract (*shart mulaim lil aqd*) like pledge and security. The third category comprises conditions which are in customary use in the geographical area (*shart mutaraf*) examples would be any local trade practices or trade customs. Any other conditions which fall outside the above stated categories and which have the effect of being advantageous to one of the parties are prohibited (*shart fasid*).⁸⁸ The basis of the restriction is the protection of the parties from being exploited and ensuring a just and equitable transaction.⁸⁹

The other Sunni schools of thought the *Shafites* and the *Malikites* follow in essence the *Hanafite* position and are not considerably dissimilar from that of the *Hanafites* with regard to the rules relating to the condition in a contract (*shurut*).⁹⁰

However The *Hanbalite* point of view on the subject of conditions (*shurut*) is by far the most lenient amongst the main schools of thought and is more pragmatic keeping in view the modern face of trade and finance. It is this flexibility of the *Hanbalite*

⁸⁶ Arabi (n 64) 50

⁸⁷ Obeid (n 63) 33

⁸⁸ Obeid (n 63) 36

⁸⁹ S Qutub, *Social Justice In Islam* In A Khurshid (Ed), *Islam Its Meaning And Message* (The Islamic Foundation, Leicester 1980)

⁹⁰ Diwany (n 28)

point of view that prompted the Ottoman Empire to shift its law relating to contract from the *Hanafites* jurisprudence to a *Hanbalite* jurisprudence to keep pace with the then modern practices of trade and commerce.⁹¹ The prominent *Hanbalite* scholar *Ibn Taymiyyah* was of the opinion that all contracts and conditions not expressly forbidden by the *sharia* were allowed. He wrote: “The parties decide as they wish the content of their juridical acts and determine the effects on the condition that these effects are not contrary to public order and morals.”⁹² In essence this was the first time in history that the Muslim scholars accepted freedom of contract in line with the more western understanding of the concept. However the emphasis still lay in the freedom of contract within the moral bounds and public order, which meant that freedom of contract was held captive to the ethical, social, moral and justice standards as espoused by the Quran and the teachings of the Prophet Muhammad and ensured that the disparity of bargaining position would not allow one party to unjustly treat the other party.⁹³

ii. Object of contract

The second of the heads under which the Islamic law on contracts can be analysed is the head of the ‘object’ of a contract. Here the word ‘object’ of the contract refers to the subject matter that forms a part of a contract and this aspect is also well regulated under the Islamic law.⁹⁴ This forms another barrier to what is normally understood as freedom of contract for the parties. The purpose of this particular prohibition is to regulate all contracts in such a way that they remain within the ambit of the division of permissible (*halal*) and the prohibited (*haram*) in the

⁹¹ Arabi (n 64) 29-50

⁹² Obeid (n 63) 38

⁹³ M Musa and S M Salleh, ‘The Concept of Total Quality In Islam.’ (2002). IKIM Journal. 10 (1), 1-19

⁹⁴ Musa (n 65)

Sharia.⁹⁵ The trade of the *Haram* items is strictly banned in sharia and many verses in the Quran clearly state what is *haram* (prohibited).⁹⁶ The purpose again is to prevent contracts that contravene Islamic injunctions regarding certain objects that are considered illicit and to maintain a balance between exchanged benefits so that no gain is made through trade of these objects. Many of the principles regarding the objects of a contract have an overlap with the concept of *Gharar* (uncertainty or speculative trading) that will be discussed in more details below. For example for an object to be licit or *mashru'* (permissible or legitimate) it must be in existing at the time of agreement, there must be a possibility of performance or the contract must be capable of performance, legitimate (according to the tenets of Islam) and its characteristics (quality, specie, genus and value) must have been settled.⁹⁷ The uncertainty of the existence, quantity, quality etc of a subject matter may render a contract void under the *sharia*, this being a main principle of Islamic finance as embodied in the financial instrument of *Salam* contract. There are however exceptions to this rule which will be discussed under the concept of *Gharar* (below) and in the next chapters when the contracts of *Mudarabah*, *Musharakah*, *Murabaha*, as examples of financial instruments being utilised in modern day IFI's are discussed. There is yet another category of prohibitions in Islamic law regarding contracts, for example some contracts are prohibited because the reason or *sabab* behind them diverges from the set principles and moral ethos of Islam.⁹⁸ An example of this could include anything that is grown to manufacture alcoholic drinks, like

⁹⁵ Y Qaradawi, *The Lawful And The Prohibited In Islam* (Dar El- Shorook, London. 1980)

⁹⁶ These are too numerous in numbers to quote here, but the most often cited ones are the ban on alcohol (which entails the production, sale, distribution, storage etc), the ban on pig meat, the ban on gambling, the ban on pornography. These are the items that are banned besides the ban on *riba* and *gharar* as discussed below.

⁹⁷ Diwany (n 28)

⁹⁸ Obeid (n 63)

grapes or wheat, which in itself is not *haram* (illicit) but the reason for them being grown is an illicit purpose that is to produce wine or beer.⁹⁹

7. The concept of *halal* (lawful and allowed) and *haram* (unlawful and banned)

One of the main tenants of the Islamic teaching is the very strict bifurcation between what is considered right or *Halal* and what is considered wrong and forbidden or *Haram*. The *Halal* and *Haram* categorisation lay at the two extremes of the spectrum of what is permitted and/or prohibited in Islam and thus derive the jurisprudence as well as the philosophical underpinning of the Islamic teachings regarding everything and therefore according to Kevin “any human act will fall under one of the following five types: obligatory (*wajib or fard*), recommended (*mandub*), reprehensible (*makruh*), permissible (*mubah*) and forbidden (*haram*).”¹⁰⁰

Kamali also contends that: “while the first and last types of activities (*wajib and haram*) have legal force, the remaining three activities fall in the domain of morals that cannot be adjudicated in courts. When *Sharia* proscribes usury or gambling, these become legal obligations.” However, as an example, Islamic teachings encouraging people not to cause injury to women and elderly or animals reflect “the moral underpinnings of *Sharia*” (whereby there is no obligation as such to do so; however it is greatly appreciated by God if done).¹⁰¹

As with everything else in Islam, Islamic economic system makes very categorical distinctions between what is permitted being lawful (*Halal*) and what is forbidden

⁹⁹ Qaradawi (n 95)

¹⁰⁰ A K Reinhart, ‘Islamic Law As Islamic Ethics’ (1983), *The Journal Of Religious Ethics*, 11 (2), 195

¹⁰¹ M H Kamali, *Shari’ah Law: An Introduction* (One world Publications, Oxford 2008)

being unlawful (*Haram*), and thus gives us the moral and legal underpinning of modern day Islamic finance industry. Thus to determine what is permitted or lawful (*Halal*) and what is forbidden or unlawful (*Haram*) for Muslims remains the sole prerogative of God and that is by far the most distinctive feature of Islamic economics and business practices.¹⁰² Accordingly, under the notions of Islamic moral economy none but God is empowered to pronounce what is right and what is wrong and a clear demarcation has thus been made between lawful and unlawful aspects in the economic sphere. Therefore, man under Islamic law has been allowed to participate in activities which are deemed lawful and has been strictly forbidden to participate in those that are deemed unlawful.¹⁰³ At a philosophical level, there can then be a further categorisation of activities that may be allowed under the *Sharia*, but if they lead to an unfair and unjust result or are contrary to any other principles of Islamic teachings these activities can then be considered unlawful. An example of this kind of activity/ action would be lending money, which in itself is allowed but if the money is lent for gaining interest then it is considered unlawful and *Haram* and comes under the ambit of Usury.¹⁰⁴ This is one of the rationales behind banning *Riba*/Usury and speculative trading, to ensure that the exploitation of the borrower is curtailed.¹⁰⁵ Thus in essence Islamic economic and business is an ethically motivated principle based system where all activities are to be carried out according to certain ethical and legal principles at both the Macro and micro level making Islamic economics and business teachings unique and demanding in practice.¹⁰⁶ It is this strict adherence to the principles of right and wrong and *Halal*

¹⁰² Usmani (n 12)

¹⁰³ Naqvi (n 8)

¹⁰⁴ Usmani (n 12)

¹⁰⁵ This Will Be Discussed In More Detail In Chapter 4 And 5

¹⁰⁶ F Pomeranz, 'Business Ethics: The Perspective of Islam.' (1995) *The American Journal of Islamic Social Sciences*. 12 (3), 400-404

and *Haram* enunciated by the Islamic teachings regarding economics and business that makes an economic and business environment uniquely ‘Islamic’.¹⁰⁷

Thus no human being has power to say what is right (*Halal*) and what is wrong (*Haram*) unless ordained by the established sources of the Sharia.¹⁰⁸ The *Qur’an* clarifies this principle in unambiguous terms when it commands: “And speak not concerning that which your own tongues qualify (as clean or unclean), the falsehood: “This is lawful, and this is forbidden”, so that ye invent a lie against Allah...”¹⁰⁹ and “O ye who believe! Forbid not the good things which Allah hath made lawful for you, and transgress not, Lo! Allah loveth not the transgressors. Eat of that which Allah hath bestowed on you as food lawful and good and keep your duty to Allah in whom ye are believers.”¹¹⁰ This is uniquely pertinent to the Islamic financial industry, whereby some activity which may be following Islamic edicts in ‘form’ however still leading to exploitation and injustice for the parties involved, can be categorised as reprehensible (*makruh*) or permissible but discouraged (*mubah*), if not entirely *Haram*. This is why the debate in Islamic finance regarding ‘Form’ over ‘substance’ has been at the center stage of the larger regulatory debate because there is a very strong argument that modern day Islamic finance is not following the principles of justice, fair play and non-exploitation, which is the actual essence of Islamic economic system, however the modern day Islamic banking practices lead to exploitative practices by charging markup rather than interest per se and the financial instruments being utilized emulate the conventional financial instruments rather than true partnership form. From a regulatory point of view, it is thus argued that a regulatory arrangement should therefore be in place which caters

¹⁰⁷ Naqvi (n 8)

¹⁰⁸ Nyazee (n 43)

¹⁰⁹ The Quran (16:116)

¹¹⁰ The Quran (5 : 87-88)

to the ‘substance’ and ‘essence’ of the principles of Islamic finance, rather than strict adherence to rules and ‘Form’.

8. Using the concept of *Maqasid al sharia* and *Masalah* as a source of sharia

It is therefore argued that to encapsulate the issue of substance and form, the Islamic finance industry should be turning to an already well-established concept in *Fiqh*, that of *Maqasid al Shari* and *Maslahah*.¹¹¹ As has been discussed above that the Islamic financial institutions because of their religious nature cannot be considered as a single dimensional profit making entities, they embody an actual religious activity for many of the Muslims who want an alternative to the conventional interest based financial system.¹¹² These two concepts are based on religious principles of sharia which further embodies other ethical principles of justice, equity, non-exploitation, transparency, social and economic welfare of the society, non-speculation, Interest free transactions as well as based on certain legal principles derived from the basic sources of Islamic commercial and business based laws. These and other unique features make the whole industry unique in its nature, both in ‘substance’ and ‘form’, but more so in ‘substance’.¹¹³ Thus the essence of Islamic finance lays in its ethical principles which are predicated on the normative results that the industry ought to be aiming to achieve. These normative principles and outcomes are attributable to the doctrine of what is called *Maqasid al Shariah* in

¹¹¹ J Auda, *Maqasid al-shariah an introductory guide* (IIT 2008)

¹¹² L Rethal ‘Whose legitimacy? Islamic finance and the global financial order’ (2010), review of international political economy, 18:1, 75-98

¹¹³ M Asutay ‘ Conceptualising and Locating the Social failure of Islamic finance: aspiration of Islamic moral economy vs the Realities of Islamic finance’ (2012)., Asian and African area Studies, 11(2):93-113

traditional and contemporary *Fiqh*.¹¹⁴ *Maqasid al Sharia* in essence can be translated to simply mean the objectives of Islamic law, though this is too simplistic a definition, however for the sake of clarity we will refer to *Maqasid al shariah* as the intended objectives or outcomes that sharia aims to achieve.¹¹⁵ This particular concept has a significant role to play in the modern day Islamic finance industry, specifically because the Islamic finance industry claims itself to be adhering to the basic principles of sharia pertaining to finance like providing services and financial instruments devoid of *Riba*(usury) and *Gharar* and upholding the basic tenet of Islamic commercial law(*Fiqh al muamlat*). It is thus argued that the regulatory and governance framework that the Islamic finance industry ought to adopt must be sharia compliant as well, however as we will see in the next chapter while discussing the possible effectiveness of the Islamic moral economy,¹¹⁶ that such a framework will not always be possible due to the fact that Islamic finance as an industry is now operating in jurisdiction where sharia is not accepted as a source of law, which may create a conundrum for individual IFI's as well as regulators and standard setting bodies. It is therefore argued that one possible option that these individual IFI's as well as the industry may benefit from is to focus on the *Maqasid al Sharia* framework. This it is argued will give the regulatory bodies as well as the industry the flexibility and convenience to follow the main guiding normative principles of sharia and focus on the outcome rather than be tied down by strict rules, while maintaining the essence of sharia in their day to day working.

¹¹⁴ A Dasuki and A Abozaid 'A critical appraisal of the challenges of realizing Maqasid al-Sharia in Islamic banking and Finance' (2007), IIUM Journal of Economics and Management, 15:2, 143-165

¹¹⁵ U Chapra ' The Islamic vision of development in the light of *Maqasid al-Sharia* ' (2007), Working paper, Islamic Development Bank

¹¹⁶ M Asutay ' Political economy approach to Islamic Economics: Systemic Understanding for an Alternative Economic System' (2007), Kyoto Bulletin of Islamic Area studies, 1-2, 3-18

Here in the context of Islamic economics and finance, the pursuit of *Maqasid al Sharia* would also encapsulate the essence of another legal doctrine of Sharia: that of *Maslaha* (consideration of Public interest), *Maslaha* being one of the aims of the overall *Maqasid al sharia* framework. In essence *Maslahah* is a doctrine which according to *al Ghazali* as reiterated by Kamali ‘secure a benefit or prevent harm but which are simultaneously harmonious with the Objective (*Maqasid*) of the Sharia’.¹¹⁷ Thus the doctrine of public interest in an economic sense is to be reflected in the activities of the economic agents,¹¹⁸ be it the IFI’s or the individuals carrying out business activity, so any activity which harms the public interest would fall foul of the overall sharia framework and be deemed unacceptable. It is therefore argued that Islamic finance as an industry ought not to be pure profit maximising entities(which is different from profit making entities), and ought to take into account other social and ethical aspects as embodied in the overall teaching of Islamic ethics and elaborated by the numerous edicts of sharia. This it is argued in this thesis can be achieved by contemporary IFI’s by adopting the stakeholder and CSR model of governance,¹¹⁹ which would mean that these IFI’s will not only be adapting a more universally accepted governance mechanism but would actually be catering to the sharia needs of their stakeholders.

In the economic sphere the *Maqasid al sharia* can be considered to be aimed at promoting social and economic welfare, equitable distribution of incomes, public welfare, act as a catalyst for development, abolition of Usury and speculative trading and avoiding evil, in essence the financial institutions ought to be ethical in their

¹¹⁷ M Kamali. *Principles of Islamic Jurisprudence* (The Islamic Texts Society, 2006, 3rd ed) 351

¹¹⁸ Felicitas Opwis ‘Maslaha in Contemporary Islamic Legal thought’ (2005) *Islamic law and society*, vol 12, No 2, 182-223

¹¹⁹ A W Dasuki, *Corporate social responsibility of Islamic banking in Malaysia: a synthesis of Islamic and stakeholder’s perspectives* (PhD Thesis, Loughborough University, UK. 2005)

operations.¹²⁰ *Maqasid al sharia* besides providing principled guidelines for the operations to the industry also can be used to gauge the results and the intended outcome. This it is argued can be considered a part of the outcome and principle based regulatory framework that the international regulatory bodies like the IFSB and AAOIFI should endeavour to replicate in their standards. It is also argued that the IFSB and the AAOIFI can use the stakeholder corporate governance model and the business ethics model to emulate as well as integrate the *Maqasid al Sharia* framework in the proposed outcome based regulatory structure, focusing on ensuring compliance mechanisms which are in line with both *Maqasid al Sharia* as well the stakeholder governance model.

However for the purposes of this thesis it is argued that the reference to Islamic business ethics in context of Islamic finance would encapsulate both the guiding principles of Islamic Moral economy as enunciated by Asutay¹²¹ as well as the desired outcomes of the *maqasid al sharia* in the context of the *Tawihidi* framework as elaborated by Chapra,¹²² Neinhaus,¹²³ Ibn Ashur¹²⁴(2006), Siddiqi (1988), Al-Najjar¹²⁵, Dasuki¹²⁶ and Jasser Auda.¹²⁷ It is therefore argued that corporate governance theory that is used for the Islamic finance industry have to encapsulate the *Tawihidi* framework which takes into account the *Maqasid* and *Masalah* aspects of Islamic Jurisprudence. In essence it can therefore be argued that as long as the Islamic finance industry caters for the *Maqasid* and *Maslaha* aspects of economic

¹²⁰ V Nienhaus 'Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance' (2011) *Ethical Perspectives*, Vol. 18, No. 4, 891-623

¹²¹ Asutay (n 113)

¹²² Chapra (n 115)

¹²³ Neinhaus (n 119)

¹²⁴ M Ibn Ashur, *Treatise on Maqasid al-Sharia* [Translated by M El Misawi] (Washington: International Institute of Islamic thought, 2006)

¹²⁵ M Al-Najjar, *Maqasid al-sharia bi ab adjadidah* (Beruit: Dar Al-Gharb al-Islami 2006)

¹²⁶ Dasuki and Aboizad (n 114)

¹²⁷ Jaser Auda (n 111)

activity, the *Tawahidi* framework will automatically be catered for. It is therefore further argued that the stakeholder theory of corporate governance with its theoretical roots in Business ethics is the closest the Islamic finance industry can come to in following the *Tawahidi* framework.

9. Riba and Gharrar: an introduction

According to Noor the ‘Two cardinal Sharia doctrines that have held sway in the development of Islamic contract law through history are: *Riba and Gharar*. Looking at these doctrines and their juristic interpretations enables us to understand the past and to project the future of Islamic law of contract’.¹²⁸ Thus by this definition the basis of Islamic contract law in specific as well as Islamic finance in general is the ban on *Riba*(Usury) and *Gharrar* (speculative trading) and this then forms an absolute rule for any financial or commercial activity under the *Sharia*. This ban may be supplemented by other conditions and terms, but these two elements remain constant and need to be understood by anyone trying to study and understand Islamic finance.

10. Riba

The prohibition on *Riba* in the Quran has been the most emphasized edict regarding the financial life of a Muslim and there have been many revelation/ verses in Holy Quran regarding Prohibition of *Riba*: the first of the *surah*’s from the Quran says “Those who swallow down usury cannot arise except as one whom *Shaitan* (Satan) has prostrated by (his) touch does rise. That is because they say, trading is only like usury; and Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of *Allah*; and whoever returns (to it)-- these are

¹²⁸ Noor Mohammed ‘Principles Of Islamic Contract Law’(1988) Journal Of Law And Religion, Vol. 6, No. 1, 115-130 <http://Www.Jstor.Org/Stable/1051062> ,Accessed: 17/09/2010 08:26

the inmates of the fire; they shall abide in it.”¹²⁹ In the second *Surah* the Quran say: “*Allah* does not bless usury, and He causes charitable deeds to prosper, and *Allah* does not love any ungrateful sinner.”¹³⁰ In the third *surah* the Quran further emphasises: “O you who believe! Be careful of (your duty to) *Allah* and relinquish what remains (due) from usury, if you are believers.”¹³¹ The fourth *surah*: “O you who believe! Do not devour usury, making it double and redouble, and be careful of (your duty to) *Allah*, that you may be successful.”¹³² The fifth and the sixth *surah* read: “And their taking usury though indeed they were forbidden it and their devouring the property of people falsely, and we have prepared for the unbelievers from among them a painful chastisement.”¹³³ “And whatever you lay out as usury, so that it may increase in the property of men, it shall not increase with *Allah*; and whatever you give in charity, desiring *Allah's* pleasure-- it is these (persons) that shall get manifold.”¹³⁴

In contemporary and classical Islamic jurisprudence the word *Riba* has been held to mean ‘excess’, ‘increase’ or ‘addition’, which correctly interpreted according to *Sharia* terminology, implies any excess compensation without due consideration (consideration does not include time value of money).¹³⁵ This definition of *Riba* is derived from the Quran and is unanimously accepted by all Islamic scholars.

Besides the *Quranic* edicts regarding *Riba* there are some agreed upon *hadith*¹³⁶ which dictate the contemporary as well as classical rules regarding *Riba*. *Riba* in

¹²⁹ (Surah, Al-Baqara, Chapter #2, Verse 275): The Quran

¹³⁰ (Surah, Al-Baqara, Chapter #2, Verse #276)The Quran

¹³¹ (Surah, Al-Baqara, Chapter #2, Verse #278) The Quran

¹³² (Surah , Aal-E-Imran, Chapter #3, Verse #130)

¹³³ (Surah, An-Nisa, Chapter #4, Verse #161)

¹³⁴ (Surah , Ar-Room, Chapter #30, Verse #39)

¹³⁵ K Ahmad, *Elimination Of Riba: Concept And Problems* in K. Ahmad. *Elimination Of Riba From The Economy* (Institute Of Policy Studies, Islamabad 1994) 33-36

¹³⁶ By almost all the classical schools of thought in islamic jurisprudence, however there are many *hadith* which have proven to be more controversial and will thus not be touched upon. even within these agreed upon *hadith* there is some debate about whether they are in essence enough to explain

Hadith start from Jabir ibn ‘Abdallah, giving a report on the Prophet Mohammad farewell Pilgrimage said: The Prophet, addressed the people and said, ‘All of the Riba of Jahiliyyah¹³⁷(literal meaning Ignorance) is annulled. The first Riba that I annul is our Riba, that accruing to ‘Abbas ibn ‘Abd al-Muttalib (the Prophets’s uncle); it is being cancelled completely.’¹³⁸ From ‘Abdallah ibn Hanzalah: the Prophet said ‘A dirham of Riba which a man receives knowingly is worse than committing adultery thirty-six times’ Bayhaqi has also reported the above *hadith* in *Shu’ab al-iman* with the addition that ‘Hell befits him whose flesh has been nourished by unlawful.’¹³⁹ From Abu Hurayah: The Prophet said: ‘God would be justified in not allowing four persons to enter paradise or to taste its blessings: he who drinks habitually, he who takes Riba, he who usurps an orphan’s property without right, and he who undutiful to his parents.’¹⁴⁰

In another *hadith*, Usamah ibn Zayd reported that the prophet Muhammad said that ‘there is no *Riba* except in *Nasia’h*(waiting).’¹⁴¹ But Muslim narrated on the authority of ‘Abu Sa‘id Al-Khudriy that Bilal, one of the prophet’s companions visited the Prophet Muhammad with some high quality dates, and the Prophet inquired about their source. Bilal explained that he traded two volumes of lower quality dates for one volume of higher quality. The prophet said: ‘this is precisely

the concept of riba,(Read: Dr. Mohammad Omar Farooq, *Riba, Interest And Six Hadiths: Do We Have A Definition Or A Conundrum?*)

¹³⁷ Literal meaning ignorance, however this refers to the time period in Arabia before the coming of Islam

¹³⁸ Sahih Al Muslim, Kitab Al Hajj, Bab Hajjati Al Nabi May Also In Musnad Ahmad as Quoted in Diwany 2010 (n 28) 100

¹³⁹ Mishkat Al-Masabih, Kitab Al-Buyu’, Bab Al-Riba On The Authority Of Ahmad And Daraquntni)

¹⁴⁰ Mustadarak Al- Hakim, Kitab Al –Buyu’

¹⁴¹ Sahaih Al-Bikhari, Book Of Sales, Bab: The Sale Of Dinars On Credit’ Nos 2178 And 2179, 169 as Quoted in Diwany (n 28) 104

the forbidden Riba! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other.’¹⁴²

In another stead *jabir ibn Abdullah* narrated that the prophet cursed the receiver and the payer of Riba, the one who record it and the witnesses to the transaction and he said: They are all equal (in guilt)’.¹⁴³

One of the most significant understanding and detailed explanation of what *Riba* entails is derived from this particular *hadith*: Abu Sa’id al khudri reported that the Prophet Muhammad said: ‘Gold is to be paid for by gold, silver for silver, wheat by wheat, barley by barley, dates by dates and salt by salt, like for like and equal for equal, payment made by hand to hand. He, who makes an addition to it or asks for an addition, deals in Riba’.¹⁴⁴

At this point it has to be mentioned that the detailed study of the actual meanings of all the *hadith* and *Quranic* edicts regarding *Riba* and its resultant debate(s) is beyond the scope of the present study as the study requires in detail and in depth analysis of both contemporary and classical teaching referring back to almost a thousand years of views, research and opinions spanning the most prominent scholars belonging to the major schools of juristic thought in Islamic *Fiqh*(Jurisprudence) and thus only those views which are regarded as having been agreed upon by most scholars will be dealt with here.

In more specific terms Nabil A Saleh has given a more contemporary definition of Riba which takes into account most of the classical as well contemporary understanding of the concept of Riba as:

¹⁴² Sahih Muslim, Book Of Al-Musaqah, Bab 96; ‘The Sale Of Food Items-Like For Like’, No. 4083, 954, As Quoted in Diwany (n 28) 104

¹⁴³ Sahih Muslim, Book Of Al-Musaqah, Bab 105, No 4093, 955 As Quoted in Diwany (n 28) 101

¹⁴⁴ Sahih Muslim, Book Of Al-Musaqah And Muzara’ah, Bab 14: “Riba”, No 4064, 953 As Quoted in Diwany (n 28) 103

Riba in its *sharia* context can be defined, as generally agreed, as an unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to effect the exchange of two or more species, which belong to the same genus and are governed by the same 'efficient cause' (*illa* in Arabic). Deferred completion of the exchange of such species or even of species which belong to different genera but are governed by the same cause (*illa*) is also *Riba*, whether or not the deferment is accompanied by an increase in any one of the exchanged counter values.¹⁴⁵

In their writing Iqbal and Mirakhor have quoted Lane's lexicon as comprehensively covering the meaning of the concept of *Riba* as meaning 'to increase, to augment, swelling, forbidden 'addition', to make more than what is given, the practicing or taking of usury or the like, an excess or an addition, or an addition over and above the principal sum that is lent or expended.'¹⁴⁶ Deriving a simpler version of the definition of the term *Riba*, Iqbal and Mirakhor have given their own streamlined definition in economic terms as: 'the practice of charging financial interest or a premium in excess of the principal amount of a loan.'¹⁴⁷ In his writing Tarek al Diway has pointed out that (either or both) the following feature that will need to be present in any *Riba* transaction: 'first, a surplus (*al fadl* in Arabic) in the amount of the counter value over the other in barter transactions of specific commodities and/or secondly, a delay (*al-Nasa* or *al-Nasi'ah* in Arabic) in the settlement of one or both counter values.'¹⁴⁸

¹⁴⁵ N A Saleh, *Unlawful Gain and Legitimate Profit In Islamic Law, Riba, Gharar And Islamic Banking.* (Cambridge University Press, 1986) 13

¹⁴⁶ Z Iqbal and A Mirakhor, *Financial Contracting And Riba(Interest)* in Z Iqbal And A Mirakhor, *An Introduction To Islamic Finance , Theory And Practice* (Jhon Wiley And Sons' Pte Ltd. 2007) 54

¹⁴⁷ Ibid Iqbal and Mirakhor 54

¹⁴⁸ Diwany (n 28) 99

It is however pertinent to further point out that the context of all these revelations in the *Quran* and the *hadiths* will be discussed as it relates to our current study. The context is the emphasis of the Islamic jurisprudence relating to trade, economics and finance on the aspects of justice, eliminating economic and social exploitation, resource mobilization, eliminating greed and hoarding of resources, focusing on ethical and moral dealings, honesty, contributing directly and indirectly to the society as a whole specially taking into account that segment of society who cannot contribute to economic activity and thus are unable to reap the benefits of the market.

11. The substance over form debate: the Riba conundrum

Whatever the controversy in the definition of *Riba*, the essence of the whole ban is to stop exploitation of either of the parties involved in the transaction. That is the ‘substance’ or the *Maqasid*¹⁴⁹ of the ban on *Riba* in the *Quran and the Hadith* and it should be considered and preferred over the ‘form’ when analysing a particular transaction and deciding whether that transaction falls within the ambit of *Riba* as espoused in the *Quran* and other sources of *Sharia* or not. In essence the conundrum regarding the ban emanating from the *Quranic* injunctions and the recognised *hadiths* of the Prophet Mohammad is whether to blindly follow the ‘form’ or the ‘substance’ of the ban on interest/ usury/ *Riba* and thus mould the practical guide lines for the contemporary Islamic finance practices in such a way as to ensure strict compliance with all the rules that emanate from the debate. On the other hand, the other fundamental question that arises is whether the *Ulema* (specifically those sitting on the SSB’s of the individual IFI’s or those sitting on the

¹⁴⁹ This is the short form of the complete word *Maqasid Sharia*, which in essence means the reason for the particular edict. This concept is discussed in more detail below

central regulatory and standard setting bodies) ought to be more flexible in looking at what the outcome of a particular transaction is going to be and decide whether that falls within the ambit of *Riba* or not. This ban on *Riba* in all its manifestations, contemporary as well as traditional, emphasises on the aspect of fairness, justice and ethical practices in dealings with others. Even where at times certain kinds of *Riba* transactions are allowed they are still deemed immoral or discouraged (even though legal). The rationale given by all scholars across the broad spectrum spanning the different juristic schools, historical eras or specialisations (economics, law, *Fiqh*, finance etc) is that Islam focuses on the morality or the ‘Substance’ or the *Maqasid* of the transactions and not per se the ‘Form’.

That is why a large part of the *Riba* debate revolves around the concept of loan giving (*qard*), a mainstay of contemporary banking industry. The Islamic injunctions are very categorical about the standing of loans, they are to be charitable, if the borrower can repay it back, then he must, but if the borrower cannot pay back the loan, the lender should give up the claim rather than trying to extract further payments by imposing an interest over the principal, which in essence leads to the existence of *Riba al jahilya*(a kind of *Riba* that was practiced in Arabia at the time of Prophet Muhammad).¹⁵⁰

There are thus very clear injunctions in Islam about the loans, as mentioned by Saleh in his writings according to the well-known Islamic scholar Sanhuri ‘the *qard*(loan) contract is basically a gratuitous transaction and thus it negates the existence of *Riba*’.¹⁵¹ But then he goes on and argues that by analogy the loan can become a

¹⁵⁰ The debate surrounding the present status of the loans is too long and requires an in-depth analysis of the works of the traditional schools of *fiqh*, which cannot be carried out here. It should suffice to say that an interest bearing loan where the interest has been stipulated beforehand is banned in Islamic banking under the *Riba* ban. For more details analysis see, Nabil Al Saleh (n 119)

¹⁵¹ Saleh (n 119) 36

rabawi transaction (*rabawi*: meaning susceptible to *Riba*) by analogy with sale when it secures to the lender an interest or a premium.¹⁵²

Of course these provisions have to be taken in context of the whole business ethics perspective under contemporary Islamic finance literature. That is why Islamic business ideology focuses mainly on fostering partnerships and trade rather than giving simple loans, it is argued by scholars and all the academics that by doing so at the Macro level the economy can not only prosper but there is economic stimulation which should lead to more distributive justice and welfare for the whole society, which is what the Islamic economic system aims to achieve. In essence the *Maqasid Sharia* behind the ban of *Riba* is the overall stimulation of economy and ensuring that there is more distributive justice while decreasing exploitation of vulnerable parties.

It is however accepted that from a purely contemporary economic perspective most of these provisions banning *Riba* and *Gharar* in Islamic finance literature and ethos may seem archaic and slightly terse for the contemporary business entity, but it has to be understood that Islamic finance isn't just about business practices; it is a part of the whole Islamic life style and not just a means to an end. And any practices that may be exploitative and unjust should be discouraged and avoided by modern day IFIs.

12. Gharrar

Gharrar basically means 'Uncertainty, risk and speculation'.¹⁵³ The concept of *gharrar* is derived from the doctrine of the *Quran* where out of concern for the possibility of human beings harming themselves from their own folly and

¹⁵² Saleh (n 119) 36

¹⁵³ Saleh (n 119) 48

extravagance, the *Quran* has banned games of chance/ hazard(gambling and speculations) in *surah .II:219* and s.V:93 of the *Quran* which says:

They ask you about wine and gambling. Say, "In them is great sin and [yet, some] benefit for people. But their sin is greater than their benefit." And they ask you what they should spend. Say, "The excess [beyond needs]."Thus *Allah* makes clear to you the verses [of revelation] that you might give thought.¹⁵⁴

Another tradition that has led to the suspicion towards *Gharrar* is the concept of protection of one party with a stronger bargaining position from exploiting the weaker of the two parties and thus giving rise to the command that all commercial and business transactions should be devoid of any uncertainty and speculation and this could only be secured through ensuring that both the parties have perfect knowledge of the counter values intended to be exchanged.¹⁵⁵ Thus the reason for the modern day suspicion of *sharia's* scholarship of any transaction that entails any kind of transaction where the subject matter, the price or both are not determined and fixed in advance, is that any such transaction would fall short of the requirements of '*Gharrar*'.

The Definition of *Gharar* has been of some controversy amongst the scholars of Islam both traditional and contemporary, some of the most prominent scholars have given their understanding of *Gharar* in the light of both the *Quran* and the teaching of the prophet Muahamad as well as on the basis of *Ijma* and *Qiyas*. Ibn Qayyim Al-Jawziyya¹⁵⁶ defined *Gharrar* as being the subject matter that the vendor is not in a position to hand over to the buyer, whether the subject matter is in existence or not. Sanhuri¹⁵⁷ on the other hand focused on the '*jahl*'(the want for knowledge), saying

¹⁵⁴ The Quran as quoted in Nabil A.Saleh (n 119) 49

¹⁵⁵ Saleh (n 119) 50

¹⁵⁶ Ibn Qayyim Al-Jawziyya, I'Lam Al-Muwwaqqi' In ,Vol.I, 357-61

¹⁵⁷ Sanhuri, Masadir Al-Haqq, Vol.III, 49

that *jahl* brings about *Gharrar* in the following circumstances: i) when it is not known whether the subject matter exists or not, or ii) if it exists, whether it can be handed over to the buyer, or iii) when want of knowledge affects the identification of the genus or species to which the subject matter belongs or its characteristics or its quantum, its identity, or its condition remaining satisfactory or iv) the want of knowledge with regard to the date of future performance, if any also creates *Gharar*. Ibn Juzay¹⁵⁸ outlined ten differing cases and circumstances where *Gharrar* is a possibility:

- a. Difficulty in putting the buyer in possession of the subject matter
- b. Want of knowledge with regard to the price or the subject matter
- c. Want of knowledge with regard to the characteristics of the price or of the subject matter.
- d. Want of knowledge with regard to the quantum of the price or the quantity of the subject matter, such as an offer to sell ‘at today’s price’ or at the ‘market price’
- e. Want of knowledge with regard to the date of future performance, such as an offer to sell when a certain event happens.
- f. Two sales in one transaction, such as selling one article at two different prices, one for cash and one for credit, or selling two different articles at one price, one for immediate remittance and one for deferred one.
- g. The sale of what is not expected to revive, such as the sale of a sick animal.
- h. The last three categories are of different sale transactions which involve the inadequate inspection of the sale object by the buyer called, *Bay ‘al-hasah*, *Bay ‘al-munabadha* and *Bay ‘mulamasa*, which is the sale performed by the vendor without giving the buyer the opportunity for properly examining the object of the sale.

¹⁵⁸ Ibn Juzay, Qawanin, 282-3

Ibn Rushd¹⁵⁹ has defined the parameters of when *Gharrar* can occur and when *Gharrar* can be avoided in the following terms: “*Gharrar* in sale transactions causes the buyer to suffer damage (*ghubn*) and is the result of a want of knowledge which affects either the price or the subject matter.” However according to Tarek “*Gharrar* can be averted if i) both the price and the subject matter are known to be in existence, ii) if their characteristics are known, iii) if their amount is determined, iv) if the parties have such control over them as to make sure that the exchange shall take place and v) if the date of future performance is defined.”¹⁶⁰

So in summary the following three conditions can be used as a guideline on how to avoid *gharrar*¹⁶¹: first of all there should be no want of knowledge (*jahl*) regarding the existence of the exchanged counter values. Secondly there should be no want of knowledge regarding the characteristics of the exchanged counter values or the identification of their species or knowledge of their quantities or of the date of future performance, if any. And third control of the parties over the exchanged counter values should be effective.

From an ethical point and *Maqasid Sharia* point of view the reason for banning *Gharrar* is simply to give both the parties the opportunity to trade on equal terms, it need not be that the parties have to have exactly the same position for that would render the concept of competitive trading completely null and void and leave Islamic finance ill-suited to modern day finance. The point is to provide justice to both parties and avoid exploitation of any one particular party. Thus any transaction or financial instrument that falls foul of the provision of *Gharar* will be deemed as *haram* (illegal and impermissible) in the eyes of *Sharia*. For the modern day IFI's to ensure that such a transaction does not occur has to be a top priority, however it is

¹⁵⁹ Ibn Rushd, *Bidayat Al-Mujtahid*, Vol.II, 148 and 172

¹⁶⁰ Diwany (n 28)

¹⁶¹ Saleh (n 119) 53

also asserted that for modern day IFI to function and compete at an international level the temptation to introduce *Gharrar* based instruments is very high as the rest of their competition in the conventional financial industry employ future based transactions like derivatives in one way or the other, which have proven to be extremely profitable for the banks. It is thus argued that IFI's need to be extra careful to ensure that they do not follow such practices as they are outside the ambit of the sharia provisions regarding finance and will surely fall foul of the *Maqasid* of the prohibition. The need is to follow a Islamic moral economic model which embodies the basic principles and tenets of *Sharia*.

13. Conclusion

It is thus argued in light of the foregone discussion regarding both *Riba* and *Gharar* and the strict conditions of the law of contract under sharia, that a regulatory and governance system for IFI's which does not take into account these specificities of Islamic finance cannot be deemed suitable for the Islamic finance industry. It is actually of essence that the services and products that IFI's offer are based purely on the basis of the Islamic law of contract(s) and ensure that no transaction has any element of *Riba or Gharar*. The principles of Islamic law are immutable and must remain so if Islamic financial industry has to succeed. Just like the general laws of Sharia, the specific issues surrounding the enforcement of contracts is an issue of great importance for IFI's to successfully operate as 'Islamic'. Therefore the adherence to *maqasid al Sharia* are deemed to be fundamental for the success of a regulatory framework which seeks to be sharia compliant as well as be flexible to adapt to modern day finance architecture.

However it is argued that one of the major hurdles for any one IFI specifically or the whole Islamic finance industry in general will be the recognition of the specific

forms of Islamic contracts or financial instruments based on the Islamic contracts in the international regulatory context. Without this recognition IFI's as an industry may never achieve their full potential. In the current regulatory framework for the IFI's in the non-Islamic countries, it is very unlikely that national regulators or the judiciary are going to recognize contracts based on sharia and therein lays a major source of contention for the Islamic finance industry. On the other hand the substance over form debate is at the heart of regulatory and governance debate for IFI's and the issues of recognition of *sharia* based contracts lies at the heart of this debate too. The focus of the whole industry and their stakeholders including the governing and regulatory bodies should be on a principle based framework which encapsulates the *Maqasid* and *Maslaha* frameworks so that the IFI's are allowed some flexibility to devise their own operations, systems, supervision, strategy, reporting, management, product development etc. competitively and according to the local laws but the over sight of the implementation/ enforcement of the sharia principles is made the top priority by both the local regulators and the Islamic financial industry itself. This, it is latter argued, can only be done if the local regulators accept, understand and facilitate in applying the basic principles of Islamic finance or allow the international standard setting bodies for Islamic finance like IFSB and AAOIFI to enforce these principles, since without this enforcement capabilities of either the local regulator or the international standard setting authorities the whole Islamic finance industry faces major systemic risks. It is thus being argued that the Islamic finance industry needs to move towards a more principle based regulatory framework where the responsibility of ensuring sharia compliance is made the responsibility of an international supra national regulatory body.

CHAPTER 3. THE ISLAMIC ECONOMIC SYSTEM AND THE IMPLICATIONS FOR BUSINESS ETHICS, LAW AND GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS

1 Introduction : Islamic business ethics

Islamic business ethics and the related law stem from the basic premise that business activity is considered to be a socially useful function leading to better social and economic conditions for society. Thus, any business activity that is deemed harmful towards the achievement of societal benefit is banned or restricted. The importance attached to business activity and its surrounding regulatory jurisprudence in a society dominated by Muslims is attributable to the fact that the Prophet Muhammad was involved in trading for much of his life; he and his early followers attached great importance to views relating to consumption, ownership, goals of a business enterprise and the code of conduct of various business agents.¹⁶²

Whilst Islamic teaching regarding business activity is wholesome in the sense that it supplies a practical life program, it is also important to note that the Islamic socioeconomic system includes detailed coverage of specific economic variables such as interest, taxation, circulation of wealth, fair trading and consumption.¹⁶³

Sharia (Islamic law) is derived from the Qur'an and *sunnah*, and covers business and buyer-seller, employer-employee and borrower-lender relationships in depth, with even the most elaborate details of business and commercial activity having been

¹⁶² G Rice 'Islamic Ethics And The Implications For Business' (Feb 1999) Journal Of Business Ethics, Vol. 18, No. 4, 345-358, Published By: Springer Stable URL: <http://www.jstor.org/stable/25074059> Accessed: 17/09/2010 08:36

¹⁶³ I N Misri 'Reliance of The Traveller A Classic Manual Of Islamic Sacred Law (IL: Sunna Books 1994)

dealt with in Islamic literature.¹⁶⁴ It follows that *sharia* acts as the governing source of business ethics, commerce, finance, law and economic norms for all adherents of Islam, whether these are individuals or society as a whole.

Further, Rossauw asserts that because Judaism, Christianity and Islam are all closely related there are in fact many ethical principles that apply to businesses (such as honesty, trustworthiness and taking care of the less fortunate) that have come to form the basis of almost all laws and codes regulating business activity, whether they be for financial services, trade, shipping or any other commercially motivated activity. However, even though modern day western business practices follow the traditional ethical ethos laid down by religious teachings, Rossauw believes the church should have no role in economic systems as it is not within the purview of the church to condemn or approve any one particular system or practice, something which has been followed in neoliberal business ethics.¹⁶⁵ This completely contrasts Islamic understanding of business ethics.

In practice, this means that western neoliberal business ethics and practices are different from the Islamic approach insofar as the whole socioeconomic system is based on religious teachings as derived from the Qu'ran alongside the teachings and sayings of the Prophet Mohamad. Rossauw further asserts that because economic systems are morally ambiguous, Christians should be encouraged to 'keep a critical distance from the economic system in which they are working'.¹⁶⁶

On account of Islamic business ethics and the business related provisions of *sharia* being derived from a strict religious source, the overall architecture of Islamic

¹⁶⁴ A A Hanafy 'Employee And Employer: Islamic Perception' (1988), Proceedings Of The Seminar On Islamic Principles Of Organizational Behaviour (International Institute Of Islamic Thought, Herndon, VA)

¹⁶⁵ G J Rossauw, '*Business Ethics: Where Have All The Christians Gone?*' (1994) *Journal Of Business Ethics* 13, 557-570

¹⁶⁶ Ibid Rossauw 562

business and economic activities maintains a careful balance between satisfying the needs of the individual along with those of society.¹⁶⁷ Islam not only allows people to satisfy all their needs, but actually encourages profit making concurrent to ensuring that profit maximisation is carried out as a useful social activity rather than out of greed. Indeed, it is this basic human urge of greed and selfish pursuit of profits that Islamic business ethics and *sharia* counters by having laid down a very elaborate system of taxation and charity at the macro level. Further, these have instituted a system of best practices in the form of a three tiered system of *Haram* (things and activities that are prohibited), *Makroh* (things and activities that are allowed but discouraged) and *Halal* (things or activities that are encouraged and allowed), as mentioned in chapter two.¹⁶⁸ In this manner, Islamic law and ethics relating to business activity remain morally and practically significant at both individual and societal level. At the same time, it maintains integrity and practicality as an economic system, which is adaptable with time and transcends geographical and jurisdictional boundaries, something which is of utmost importance for the modern day Islamic financial system.¹⁶⁹

One of the main objectives of the Islamic economic system is to set up a ‘moral filter’ whereby all economic decisions being taken by private individuals and governmental/public bodies are gauged against a set of normative moral values, after which it is decided whether that particular practice should be allowed in an ‘Islamic’ society or from a *sharia* point of view.¹⁷⁰ This gives Islamic economic and business

¹⁶⁷ M A Afzalur-Rahman, *Islam Ideology And The Way Of Life* (The Muslim School Trust, London 1980)

¹⁶⁸ Please refer to chapter 2 for a better understanding of the categorization of ‘*halal*’, ‘*haram*’ and ‘*makroh*’ in Islamic jurisprudence

¹⁶⁹ Al-'Alwani and El-Ansary, *Linking Ethics and Economics: The Role of Ijtihad in The Regulation And Correction Of Capital Markets* (Centre For Muslim-Christian Understanding: History And International Affairs, Georgetown University, Virginia 1999)

¹⁷⁰ Rice (n 144)

ethics an advantage over their conventional counterparts in the context of individual decision making and practical manifestation of religious values, since such values can be traced back to a predetermined set of principles and edicts derived from either the Qu'ran or the *sunnah* of the Prophet Muhammad.¹⁷¹ Accordingly, Islamic business ethics and practices are both flexible and certain, an elusive quality that is much sought after in conventional business ethics and one that can be attributed to the acceptance of religious values as a part of a socioeconomic system, rather than discarding religious ethos completely.¹⁷² Nonetheless, it remains an issue of great importance for Islamic financial institutions that they have a uniform system of values that are not restricted to jurisdictions where *sharia* is deemed a main source of law but are capable of international adherence by Muslims and non-Muslims alike. If the Islamic financial industry is to compete and succeed in face of intense competition from conventional financial institutions, such values are imperative.

The goals espoused by Islamic business ethos are not primarily materialist; they are based on principles of human well-being, the pursuit of socioeconomic justice, pursuit of a common good (public good or public welfare) for society and a pursuit of a good and fulfilled life, an ideology which can be traced back to the concept of *Maslaha*. All of these stress the humane aspect of all socioeconomic activities whereby harmony and balance can be achieved between that which is considered worldly and that which is considered divine and spiritual.¹⁷³ In essence, it can be said that in Islam, it is ethics that dominate economics and not vice versa.¹⁷⁴

¹⁷¹ K Ahmad, *Islamic Ethics In A Changing Environment For Managers* in A. M. Sadeq, *Ethics In Business And Management: Islamic And Mainstream Approaches* (Asean Academic Press, London 2002) 97

¹⁷² S O Alhabshi 'The Role of Ethics In Economics And Business.' (1987) *Journal of Islamic Economics*. 1 (1), 1-15

¹⁷³ M U Chapra, *The Future Of Economics: An Islamic Perspective* (Leicester: The Islamic Foundation, 2000a)

¹⁷⁴ S N H Naqvi, *Perspective on Morality and Human Well-Being: A Contribution To Islamic Economics* (Leicester: The Islamic Foundation, 2003)

There is thus a deep ideological divide between Islamic economics and a neoliberal capitalist ideology. An example of the divide between the two views can be seen in free market capitalist economies wherein the free market uses market determined prices as a filtering mechanism to distribute resources. The use of the price system alone, however, can frustrate the realisation of socioeconomic goals.¹⁷⁵ This can be attributed to neoliberal economic thought whereby the markets are thought to be inherently perfect and are considered the best possible allocators of resources amongst a society.¹⁷⁶ However, neoliberal economics are silent regarding the very complex and intensely deep question regarding the role of human behaviour in a free market economy where the markets are left to regulate themselves (something which is problematic from the Islamic business ethos point of view owing to the presumption that all men and women are naturally committed to ‘good’).¹⁷⁷ This starting point about human commitment to ‘good’ is the reason why an Islamic economic system believes in mandatory charity and associates a very high rank in this world and the life hereafter for those who are voluntarily charitable.¹⁷⁸ If this presumption is taken as the basis of the Islamic economic ethos and belief system, then the divide between neoliberal free market economy proponents and the Islamic system becomes deeper and impossible to bridge.

This basic divide can be seen manifesting itself in another way; if the overall aims and pursuits of the western neoliberal free market economic system are profit maximisation and the blind pursuit of profit, then this would mean that the whole

¹⁷⁵ Rice (n 144)

¹⁷⁶ These views have been dealt with in detail in the next chapter, ie chapter 4. These views regarding the free market mechanism can best be attributed to Milton Friedman’s extensive work and the wave of deregulations in the USA and the UK during the Thatcher and Regan era, basing on the Milton Friedman’s research and work, but can be traced back to the seminal works of Berle and Means in the wake of the ‘new deal’ in the USA

¹⁷⁷ S M Ahmed, *Economics Of Islam* in S M Ahmed, *Social Justice In Islam* (Institute Of Islamic Culture Lahore. Ashraf Publications, Lahore 1975)

¹⁷⁸ Haron (n 10)

system is based on assumption that those who can exploit the given resources to best suit their needs and wants will do so with little regard to the needs of others. In simpler terms, one would not be wrong to say that the system is predicated on greed.¹⁷⁹ Conversely, the aforementioned *raison d'être* of the Islamic economic system is the pursuance of a system which works towards a more socially and economically just society with very well sorted and established values and principles.¹⁸⁰ These values and principles are looked at as mandatory for the whole of society and thus formulate both the macro and micro level economic and business policy(s) in any given society.¹⁸¹ This contemporary argument of the whole *raison d'être* being socio economic and distributive justice is in essence the idea of *Maqasid al Sharia* of the Islamic economic system being the driving force behind many of the socio economic normative values, which is being argued in this thesis, ought to also be practised in Islamic finance.

Nevertheless, when writing about the free market and Islamic business ethics Chapra categorically states that although in some respects there may seem to be no inherent conflict amongst Islamic principles and the free market system, there is a caveat. The Islamic world view which allows the free market to be established, only does so providing that the market itself is not reliant only on price mechanisms and the supply and demand of goods and services as the sole theoretical contrivances of the free market. These mechanisms have to be predicated on the requirement that every decision that is taken in a free market is gauged according to a 'moral filter', thereby eroding the pure neoliberal capitalistic claim that the market should be left to

¹⁷⁹ A Argandona, 'The Stakeholder Theory and The Common Good' (1998) *Journal of Business Ethics*. 17, 1093-1102

¹⁸⁰ Haroon (n 10)

¹⁸¹ Rice (n 144)

regulate itself.¹⁸² The other reason for the Islamic economic system adopting a moral filter is so that the resources are allocated in a just, fair and equitable manner and not left solely to the mercy of market forces.¹⁸³ According to Siddiqi, this moral filter will ensure that resources are allocated in such a way so that the necessities are catered for before the luxuries and thus basic distributive justice is ensured for the society.¹⁸⁴

According Keynes had observed that:

the needs of human beings may seem to be insatiable...[T]hey fall into two classes: those needs which are absolute in the sense that we feel them whatever the situation of our fellow human beings may be, and those which are relative ones in the sense that their satisfaction lifts us above or makes us feel superior to others. Needs of the second class, which satisfy the desire for superiority, may indeed be insatiable; for the higher the general level, the higher still are they. But this is not so true of the absolute needs.¹⁸⁵

By contrast, some Islamic jurists have categorised goods into the following classes: categories of necessities (*daruriyyat*), conveniences (*hayiyyat*) and refinements (*tahsiniyyat*) which would fall into Keynes' first class of needs.¹⁸⁶ These may be any of the goods and services which fulfil a need or reduce a hardship and make a real difference in human well-being.¹⁸⁷

¹⁸² M U Chapra, *Islam and The Economic Challenge* (International Institute Of Islamic Thought, Herndon, VA 1992)

¹⁸³ Ibid Chapra

¹⁸⁴ Siddiqi (n 26)

¹⁸⁵ J A M Keynes, *The Collected Writings Of John Maynard Keynes* (Macmillan For The Royal Economic Society, London 1972)

¹⁸⁶ R I Beekun, 'Islamic Business Ethics.' (1996) Herndon, USA, the International Institute Of Islamic Thought

¹⁸⁷ Rice (n 144)

Chapra goes further in making a distinction between ‘comforts’ and ‘luxuries’ (the second class of needs), believing that the latter are merely ‘goods and services derived for their snob appeal and make no difference to a person’s well-being’ and must therefore be placed at the very end of the hierarchical order so that resource allocation is made in a just and equitable way.¹⁸⁸

Galbraith refers to this second class of needs as ‘wants.’¹⁸⁹ It is this classification in Islamic teachings that guides Islamic business ethics in determining which activities are to be allowed, which are allowed but discouraged, and those activities which are absolutely prohibited. This basic classification allows for the basic principles of Islam to be applied to the economic and business sphere of a Muslim’s life. This in essence is also the *Maqasid* of the classification of wants and needs under Islamic jurisprudence to ensure that focus is kept on materialistic aspects which are deemed necessary and materialistic aspects which are deemed merely luxuries so that at the Macro level the distribution of wealth is carried out justly.

2. Objectives and aims of an Islamic economic and financial system

Basing the Islamic economic system on the main principles of Islam and relying on the specific *Maqasid al sharia* for economic and commerce at a macro level means that the objectives of the modern day Islamic financial industry and what any Islamic financial institution should be normatively following at any given time can be consistently and certainly established. Below are some of these main objectives of the Islamic economic system:

a. Achievement of *falah* (welfare)

¹⁸⁸ Chapra (n 164)

¹⁸⁹ J K Galbraith, *The Affluent Society* (Houghton Mifflin, Boston, MA 1958)

The first and the foremost aim of Islam is the achievement of *falah* (the well-being of the mankind in this world and in the next). The concept of *falah* can be derived directly from the Qur'an in the following passages: 'Our Lord! Give unto us in the world that which is good and in the Hereafter that which is good, and guard us from the doom of fire...' ¹⁹⁰ and 'establishing *salat* and just economic order of *zakat* and believing in the Hereafter' ¹⁹¹ and 'following the Messenger, honouring him, supporting him and following the Light (i.e. the Qu'ran) that was revealed to him.' ¹⁹² Furthermore, 'seeking the means to be in the good graces of Allah and striving hard in His way'; ¹⁹³ 'striving hard with one's life and wealth in the way of Allah'; ¹⁹⁴ 'refraining from intoxicants, gambling and games of chance, sacrificing animals on stones i.e. altars of idols and idolatrous practices, and divining of the future by such means as arrows, raffles and omens'; ¹⁹⁵ and finally by 'making the balance of good deeds heavier than the bad deeds'. ¹⁹⁶

Thus, it can be seen from the Qu'ranic verses that the Islamic concept of *falah* is a very comprehensive, multi-layered concept as it refers to spiritual, moral and socioeconomic well-being in this world and success in the Hereafter. The first layer can be taken as the micro level; at this level *falah* refers to a situation where an individual is adequately provided for in respect of his basic needs, and enjoys necessary freedom and leisure to work for his spiritual and material advancement within the confines of the Islamic teachings. The second layer can be taken as the macro level, aiming at establishment of an egalitarian and successful society with a clean environment free from want and with opportunities for its members to progress

¹⁹⁰ The Qu'ran (2 : 201)

¹⁹¹ The Qu'ran [31:5-6]

¹⁹² The Qu'ran [7:157]

¹⁹³ The Qu'ran [5:35]

¹⁹⁴ The Qu'ran [9:88]

¹⁹⁵ The Qu'ran [5:90]

¹⁹⁶ The Qu'ran [7:8, 23:102]

in socio-political and religious affairs.¹⁹⁷ In short, at the macro level, Muslims hold that society should be working towards achieving a common and public good. This concept of welfare and the public/common good of the individual and society are not only restricted to economic prosperity but other equally important aspects as well such as moral, cultural and socio-political advancement.¹⁹⁸

The concept of *falah* (viewed strictly in the economic field) is an overarching feature of Islamic teaching regarding economics and business, principally referring to material well-being of the citizens of an Islamic state.¹⁹⁹ The economic system of Islam, therefore, aims to achieve economic well-being and betterment of the people through equitable distribution of material resources and through establishment of a socially and economically just system.²⁰⁰ Nevertheless, the basic objective of an Islamic system remains the same, which has been clearly laid down by the Qur'an thusly: [b]ut seek with [the wealth] which God has bestowed on thee, the home of the Hereafter, nor neglect thy portion in this world, but do thou good as God has been good to thee and seek not mischief in the land, for God loves not those who do mischief.²⁰¹ Therefore, the concept of *falah* can be taken as the one main aim or the basic *Maqasid* that all other principles and teachings regarding Islamic injunctions about economics and business strive to achieve. The conceptual counterpart of the word *falah* in western teaching regarding economics and business can be loosely translated to encompass the concept of welfare (and to an extent socioeconomic welfare of society), something which can only be achieved through fair and

¹⁹⁷ S M Hasanuzzaman, *Islam and business ethics*. (London: Institute of Islamic Banking and Insurance 2003)

¹⁹⁸ M Biraima 'A Quranic View Of Social Reality And Its Implications For A Universal Social Science: The Case Of Economics'(December 1996), Proceedings Of The Second International Conference On Islamic Political Economy, USM

¹⁹⁹ Haneef (n 58)

²⁰⁰ Siddiqi (n 26)

²⁰¹ The Qu'ran (28 : 77)

equitable distribution of wealth; enforcing policies and actions that lead to distributive (economic) justice for society.²⁰²

Thus the Qu'ran says:

[T]he Alms is meant only for the poor and the needy and those who are in charge thereof, whose hearts are to be reconciled: and free those in bondage, and to help those burdened with debt, and for expenditure in the way of God and for the way farer. This is an obligation from God. God is all knowing, all wise.²⁰³

This particular verse shows that the *Maqasid* of acquiring wealth in Islamic economics is to ensure that it is used for helping others (if one can do so) so that there is general prosperity in society and an increase in welfare of the people in that society.²⁰⁴ Consequently, this should remain as the main aim of a financial system espousing the principles of *sharia* and should be ensured via prudential regulatory and governance standards for all individual IFIs and stakeholders involved.

b. Fair and Equitable distribution: justice (*adalah*)

In Islamic teaching, if there was one principle to be considered the overarching edict regarding socioeconomic aspects, that one principle would be justice (*adalah*).²⁰⁵ Islamic teaching views social and economic injustice as inherently abhorrent and the main focus of all schools of thought regarding economic and social policy in Islam tends toward the eradication of inequity, injustice, exploitation and oppression.²⁰⁶

²⁰² R Wilson, 'Parallels between Islamic and Ethical Banking' (2003) In Paper Presented In Islamic Capital Market Task Force Of Malaysian Securities Commission Meeting. Melbourne, Australia. [Http: //Www. Sc. Coni. Niy/Htnil/I affairs/Ioscoislamicpdf/Parallels. Pdf](http://www.Sc.Coni.Niy/Htnil/Iaffairs/Ioscoislamicpdf/Parallels.Pdf), Accessed On 12 December 2010

²⁰³ The Qu'ran (9:60)

²⁰⁴ Z Sattar, 'The Ethics Of Profits In The Islamic Economic System: A Socioeconomic Analysis.' (1988). The Islamic Quarterly. XXXII (2), 69-76

²⁰⁵ D Abdelkader, 'Modernity, the Principles of Public Welfare (Maslaha) and The End Goals Of Shari'a (Maqasid) In Muslim Legal Thought,' (2003). Islam and Christian-Muslim Relations. 14 (2), 163-174

²⁰⁶ Rice (n 144)

This aim is considered absolute and impassable and must also form a part of the wider *Maqasid al Sharia* of all economic activities allowed by *Sharia*.

However, there are two sides of the concept of justice in Islam - one is the concept of individualism whereby every man must strive for what he can (the Qu'ran itself says: '... no bearer of burdens can bear the burdens of another...[M]an can have nothing but what he strives for...').²⁰⁷ The reason the Qu'ran is this clear about this particular feature is that it also aims to encourage each member of society to make an individual effort for their own betterment so that the whole society prospers. Conversely, Islam also propagates a very elaborate and demanding notion of social cohesion amongst people in society.²⁰⁸ Thus, if both of these supposedly opposing concepts of individualism and societal cohesion are combined, the Islamic socioeconomic model becomes very clear. According to the concept of justice (*adalah*) then, people may acquire wealth but must not use any immoral and/or illegal means like cheating or lying in doing so, this also means that man must not exploit an unwary or weaker party by virtue of his better bargaining position. Further, one must hold true to their words towards others, even if the other does not have the capacity to enforce a contract or agreement. This is because since a promise or contract made to another man is made in the presence of God himself, the breaking of such a promise and contract will amount to the cheating and betrayal of not only the other party but also of God.²⁰⁹

The Islamic principle of justice operates in every sphere of human activity, be it legal, social, political or economic. The Islamic economic system is in fact based

²⁰⁷ Qur'an 53:38-9

²⁰⁸ M Abu-Zahra, *El-Takaful El-Itimae Fil-Islam (Social Solidarity In Islam)* (Dar El-Fikr, Cairo 1957)

²⁰⁹ Haron, S 'The Philosophy of Islamic Banking.' In *Anthology Of Islamic Banking*, Edited By Asma Siddiqi, 55-58. London: Institute of Islamic Banking And Insurance, 2000

upon the principle of justice which governs all the basic aspects of the economy like production, distribution, consumption and exchange.²¹⁰

In the sphere of production, the Islamic principle of justice ensures that nobody is exploited by another and that nobody acquires wealth by unjust, unfair, unlawful or fraudulent means. The followers of Islam are allowed to acquire wealth only through just and fair means.²¹¹ Islam sanctions the right of every individual to earn his livelihood, acquire wealth, own property and live a comfortable life.²¹² However, it does not allow that people should amass wealth through bribery, corruption, embezzlement, stealing, gambling, trade in narcotics, exploitation, interest, fraud, hoarding, prostitution, malpractices in business, immoral professions or through other unjust and forbidden methods.²¹³

In the field of distribution, the Islamic principle of justice plays the most vital role. One of the greatest contributions of Islam as a social and economic system to humanity is the ensuring of just and equitable distribution of wealth among the people. Justice in distribution - commonly understood by reference to the concepts of economic justice, social justice or distributive justice - demands that economic resources should be distributed among the members of the community so that on the one hand the gulf between the rich and the poor should be bridged, and on the other everyone should be provided with the basic necessities of life.²¹⁴ Islam discourages the concentration of wealth in the hands of the few and ensures its circulation in the community; not only through moral education and training, but also through

²¹⁰ Afzalur-Rahman (n 149)

²¹¹ M U Chapra, *Towards A Just Monetary System* (Leicester, The Islamic Foundation 1985)

²¹² M H Karnali 'Fundamental Rights of The Individual: An Analysis Of Haqq (Right) In Islamic Law.' (1993) *The Islamic Journal of Social Sciences*. 10 (3), 340-366

²¹³ M I A Usmani, *Meezan Bank's Guide to Islamic Banking* (Darul Ishaat, Karachi Pakistan 2003)

²¹⁴ Naqvi (n 156)

effective legal measures.²¹⁵ It is to ensure this distribution of wealth that Islamic teaching accentuates by having established an elaborate system of *sadaqat* (charity), *zakat* (obligatory almsgiving) and voluntary almsgiving along with the laws of inheritance (which help to ensure the distribution of wealth among the larger and more affluent sections of society).²¹⁶ This is why Islamic finance as an industry needs to cohesively incorporate the ideology of distributive justice, insofar as it is possible, into the industry's dealings at the micro level, whilst the regulatory authorities and standard-setting bodies do the same at the macro level when devising regulatory and governance frameworks for IFIs. If this is undertaken, the industry can function in the true spirit of Islamic economic justice.

From a purely economic point of view the most important objective of the economic system of Islam is to distribute economic resources, wealth and income fair and equitably.²¹⁷ This concept can be taken as a derivative of the *falah* principle, refined specifically to how *falah* (welfare) can be achieved in an economic system. It is on the basis of fair and equitable wealth distribution that Islam discourages the concentration of wealth in the hands of the few and ensures its circulation amongst all sections of society. The Qur'an says: '[t]hat which Allah giveth as spoil unto His messenger from the people of the townships, it is for Allah and His messenger and for the near of kin and the orphans and the needy and the wayfarer that it becomes not a commodity between the rich among you.'²¹⁸

This means that, according to the Qur'an, wealth should not be allowed to concentrate in few rich hands, rather it should freely circulate among all the people

²¹⁵ Sattar (n 187)

²¹⁶ Usmani (n 12)

²¹⁷ Haroon (n 10)

²¹⁸ The Qu'ran 59:7

thus enabling the poor and destitute among the nation to also take benefit from it.²¹⁹

Thus, it is the primary objective of the Islamic economic system to bridge the gulf between the rich and the poor by modifying the distribution of wealth and economic resources in favour of the less fortunate.

This circulation of wealth can be achieved by: distribution of wealth in the form of *zakat* and *ushr* (Taxes on assets), voluntary distribution in the form of *Sadkah* and donations (Charity),²²⁰ and the distribution of property of a deceased person after his death (inheritance laws)²²¹ or through more positive actions like investing into business ventures such as *Musharakah* (partnerships) *Mudarabah* (agency) or *bay* (sale),²²² ensuring that wealth remains in circulation under all circumstances and is not hoarded.

The jurisprudential reason for imposing this wealth tax on the rich can be traced back to the concept of *khilafah* (trusteeship, which will be discussed later) since the basic consideration is that the rich of the society are not the real owners of wealth, they are merely trustees, and the actual owner of all resources is God himself. Thus, as the trustees of the wealth in society the rich must spend in accordance with the terms set out by the 'real' owner. One of the terms of the trust bestowed upon the rich of the society is to use the wealth to help others who are in need of it.²²³ According to Gillian Rice '[t]he word "zakah" means purification and as such, income redistribution is not only an economic necessity but also a means to spiritual

²¹⁹ Naqvi (n 156)

²²⁰ Ghamidi (n 51)

²²¹ Diwany (n 28)

²²² Iqbal and Mirakhor, *An Introduction To Islamic Finance Theory And Practice* (Wiley Finance 2007)

²²³ Siddiqui (n 26)

salvation ("...of their wealth take alms so that you might purify and sanctify." Qur'an 9:103).²²⁴ Therefore, economics is effectively integrated with ethics.²²⁵

Another aspect of the concept of justice (*adalah*) in Islam is the prohibition on usurious dealing called *riba*²²⁶ as has been discussed in detail in the previous chapter. This prohibition is predicated on the concept that usury leads to both unjust distribution of wealth and exploitation by a stronger party of a weaker party, thus leading to an extortionist attitude by the lenders and the hoarding of resources.²²⁷

The concept of distributive justice forms the central ideology of an Islamic financial system to ensure that both society and individual actors in the state guarantee the well-being of the poor, whilst simultaneously balancing the societal point of view (the enforcement of *zakat* and charitable donations etc.) with the more individualistic approach. As a result, individuals are encouraged to earn a livelihood and be entrepreneurial in order to pursue economic goals whilst remaining within the ethical, moral and legal boundaries of Islamic teaching.²²⁸ Thus, it would not be wrong to say that the Islamic economic system is entrepreneurial, yet has very strong ethical and moral limitations, making it necessary that the regulatory and governance framework is able to balance these two positions at both an individual and industry level; something which neoliberal regulatory and governance regimes do not and are thus deemed unsuitable for devising a regulatory or governance framework for IFI's.

²²⁴ Rice (n 144)

²²⁵ Naqvi (n 8)

²²⁶ M U Chapra 'Why Has Islam Prohibited Interest: Rationale Behind The Prohibition Of Interest' (2000b) *Review Of Islamic Economics*, 9 5-20

²²⁷ This will be discussed in more detail in Chapter 5 and 6

²²⁸ M Obaidullah 'A Comment On "Stakeholders Model of Governance In Islamic Economic System", (2004) *Islamic Economic Studies*. 11 (2), 71-74

c. Promotion of brotherhood and unity

Another objective of the Islamic economic system is to establish brotherhood and unity among Muslims.²²⁹ The Qu'ran says:

It is not righteousness that ye turn your faces to the East and the West; but righteous is he who believeth in Allah and the Last Day and the Angels and the Scripture and the Prophets; and giveth his wealth, for love of Him, to kinsfolk and to orphans and the needy and the wayfarer and to those who ask, and to set slaves free; and observe the proper worship and pay the *Zakat*.²³⁰

Again, the Qu'ran enjoins upon its followers: 'They ask thee, (O Muhammad), what they shall spend. Say: That which ye spend for good (must go) to parents and near kindred and orphans and the needy and the wayfarer. And whatsoever good ye do, Lo! Allah is aware of it'.²³¹ Thus, by instructing the wealthy to pay *zakat* and spend for their poorer parents, relatives, orphans and the needy, Islam lays the foundations of fellow-feeling, brotherhood, friendship and love amongst all the members of Muslim society (the *Ummah*).

Dr. Khalifa Abdul Hakim writes: 'Islam desires to mould the economic life of society in such a manner that antagonistic class divisions of millionaires and paupers shall not come into existence'.²³² Shaikh Mahmud Ahmad in his book 'Economics of Islam' writes, after discussing the injunctions of the Qu'ran regarding prayer and *zakat*, that

²²⁹ M Biraima 'A Quranic View of Social Reality And Its Implications For A Universal Social Science: The Case Of Economics,' (December 1996), Proceedings Of The Second International Conference On Islamic Political Economy, USM

²³⁰ The Qu'ran (2 : 177)

²³¹ The Qu'ran (2:215)

²³² Dr K A Hakim, *Islamic Ideology* (10th Ed Institute If Islamic Culture 2006)

[t]he brotherhood of man is not realised only by bowing together of the ruler and the subject, the lord and the peasant, the factory-owner and the wage-earner shoulder to shoulder before One God, but is established on a firm foundation even outside a mosque where the king and the lord and the factory-owner are made jointly responsible for the elementary necessities of life of the subject and the peasant and the wage-earner.²³³

Mr. M. A. Mannan writes: ‘*Salat* (prayer) rouses the feeling of equality and brotherhood between the rich and the poor, the high and the low, and *zakat* puts that feeling of brotherhood on a firm footing by making the rich and the capitalists responsible for the maintenance of the poor and the needy.’²³⁴ Thus, it is clear that the achievement of brotherhood is another aim that the Islamic finance industry must strive to achieve and is in essence the extension of the *Maqasid al Sharia* of the Islamic economic system

d. Achievement of Moral and Material Development

The modern day economic system of Islam aims (the *Maqasid*) to achieve a two pronged outcome: a material as well as moral development of the Muslim community.²³⁵ It achieves this objective through its system of taxation and fiscal management, particularly through *zakat*. The other way is through ensuring that financial intermediaries such as banks and financial institutions engage as many stakeholders as possible in financial and business activities through investments, sales and contracts.²³⁶ It is in this regard that it is felt that IFIs form a major part of

²³³ M A Shiekh, *Economics Of Islam: A Comparative Study* (M.Ashraf 1947(Reprinted 2006) 147

²³⁴ M.A.Manan, *Islamic Economics; Theory And Practice: A Comparative Study* (M Ashraf 1975) 162

²³⁵ M Cizakca, *Islamic Capitalism And Finance, Origins, Evolution And The Future* (Edward Elgar Publishing Limited UK 2011)

²³⁶ Obaidullah (n 211)

modern day financial and economic architecture for Muslims and non-Muslims alike, providing an alternative to mainstream interest free banking.²³⁷

As already mentioned one major reason for instituting a system of *zakat* is to discourage the hoarding of wealth and encouraging its circulation. Those persons who possess hoarded wealth know that if they were to keep it, it would be consumed by *zakat*. Consequently, they would not keep it lying idle, rather they would forcibly bring it into circulation by investment or expenditure.

Accordingly, such consumption and investment would then have a multiplier effect on the growth of the national income. Taxes like *zakat* are a progressive tax which means that they are levied only on those who can afford to pay a proportion of their wealth to those needier than them; when it is collected from the rich and given to those more deserving it spurs spending, this in turn pushes the economic engine forward and the wealth circulates.²³⁸ The Qu'ran perhaps refers to this situation when it compares usury and *zakat* and pronounces '[t]hat which ye give in usury in order that it may increase on [other] people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's countenance, hath increase manifold'.²³⁹ It is thus argued that by analogy, the modern day Islamic finance industry ought to be carrying out the same ideological function of ensuring the circulation of wealth whilst maintaining the moral standards espoused by *sharia* and contemporary Islamic economic literature. Accordingly, as with the collection of *zakat* and other taxes, IFIs as an industry need to be regulated in such a way that the focus is on results and outcomes whilst also concentrating on the basic principles of Islamic economics and *sharia*.

²³⁷ Chapra (n 194)

²³⁸ Ghamdi (n 51)

²³⁹ The Qu'ran (30 : 39)

At a philosophical level, *zakat* and a system of voluntary alms also helps in moral and spiritual development of Muslim society. The reason behind this seems to be embodied in the motivation of sacrifice; sacrificing one's own need for the betterment of the society and others who are more needing, thus ensuring a just and equitable distribution of wealth.²⁴⁰ This is something which the conventional business concept of corporate social responsibility (CSR), stakeholder theories and business ethics embody as well.²⁴¹ Islam promotes sentiments of sacrifice, love, goodness of heart and mutual cooperation. The Qu'ran says: "[a]nd likeness of those who spend their wealth, seeking to please Allah and to strengthen their souls, is as a garden, high and fertile...'²⁴². Payment of *zakat* and voluntary alms purifies the human soul of vices like greed, miserliness and selfishness, thus promoting a truly stakeholder oriented society wherein all persons (natural as well as artificial) are socially responsible.

3. Basic principles of Islam

In perusing the main aims (the *Maqasid*) of the Islamic economic system, a major focus has to be on the basic principles of Islam and *sharia* so that a proper Islamic economic system is instituted in both substance and form. As Islamic finance is a part of wider Islamic teachings, which deal with the social and economic aspects of society and is governed by the basic principles of Islamic teachings in general, it is imperative to understand how these basic principles effect the Islamic financial industry in modern times. Furthermore, if a unified governance and regulatory

²⁴⁰ S H Azmi 'Traditional Islamic Social Welfare: Its Meaning, History And Contemporary Relevance.' (1991). Part I-III. Islamic Quarterly. XXXV And XXXVI (3,4 And 1)

²⁴¹ Z Iqbal and A Mirakhor, 'Stakeholders Model Of Governance In Islamic Economic System' (2003) In The Fifth International Conference On Islamic Economics And Finance: Sustainable Development And Islamic Finance In Muslim Countries, IRTI, Islamic Development Bank. Bahrain

²⁴² The Qu'ran (2 : 265)

framework for the Islamic financial industry is to be determined, the basic principles of Islamic teachings will form an integral part of such an attempt. Some of the principles of the Islam, as laid down by the Qur'an and the *sunnah*, are discussed as follows.

a. *Tawhid*

One of the main features of Islamic teachings is the concept of *tawhid* (the unity of God), which also renders itself as an integral part of philosophy in Islamic laws regarding business and ethics.²⁴³ This is where the concept of the *Tawhidi* framework is derived from and thus forms a coherent ideological basis for the functioning of the Islamic finance industry. The basic premise of *tawhid* is predicated upon the symbolic relationship that man has with God and his creations, including other human beings.²⁴⁴ For Muslims relying on *tawhid* means, in essence, surrendering to the will of God and doing as one has been instructed by him and his revealed words through the Qu'ran and the teachings of the Prophet Muhammad. The concept of pure surrender to the divinity of God is a common aspect in all monotheistic religions,²⁴⁵ whereas in Islamic teaching this goes further in elaborating this concept of surrender. Islam teaches man to apply Islamic edicts to *all* aspects of a man's life; this includes his relations with other human beings because the relationship with the other human beings are considered an extension of man's servitude to God himself.²⁴⁶ This can further be explained by looking to the

²⁴³ A A Sulayman, *The Economics Of Tawhid And Brotherhood', Contemporary Aspects Of Economic Thinking In Islam* (American Trust Publications, Indianapolis, IN 1976)

²⁴⁴ Ameena Philips, *The Evolution Of Fiqh* (International Islamic Publishing House, Riyadh. Saudi Arabia 2006)

²⁴⁵ R Wilson, *Economics, Ethics And Religion: Jewish, Christian And Muslim Economic Thought* (London, Macmillan Press Ltd 1997)

²⁴⁶ F Al-Omar and M Abdel-Haq, *Islamic Banking, Theory, Practice and Challenges* (Oxford University Press, Karachi, Pakistan 1996)

teachings of the Qu'ran and the Prophet Muhammad, which urge all human beings to deal with others in a fair and just manner.²⁴⁷ Therefore, Islam is itself a manifestation of unity (*tawhid*) because it provides a practical guide of doing things as between man and God and also between man and other human beings. It follows that *tawhid* in Islam can be seen as actually meaning that there ought to be a unity of ideas and actions in a person's actions, existence and consciousness.²⁴⁸ This gives Islamic teaching relating to any particular subject a very practical outlook and thus encompasses both actions and intentions. Siddiqi explains that the fact that man is made accountable to God for all his deeds in Islamic teachings adds an additional factor of accountability and checks for the smooth running of society in accordance with set principles and values.²⁴⁹ *Tawhid* also thus means that the relationships between human beings (inclusive of social and economic relations) is as sacred as the relationship between man and God.

Gillian Rice states that '[i]n this sense, unity is a coin with two faces: one implies that God is the sole creator of the universe and the other implies that people are equal partners or that each person is a brother or sister to the other. As far as business is concerned, this means cooperation and equality of effort and opportunity'.²⁵⁰

Hassanuzzaman has very clearly defined the relationship of ethics with the concept of *tawhid* in saying:

Islamic ethics [are] expressed in terms of the immanent presence of God in earthly affairs of man. His (God's) omnipotence imbues materially reality with normative

²⁴⁷ Hassanuzzaman (n 180)

²⁴⁸ G Eaton, *Islam And The Destiny Of Man* (The Islamic Texts Society, Cambridge, 1994)

²⁴⁹ Siddiqi (n 26)

²⁵⁰ Gillian Rice (n 144)

content. Both God's law expressed in the Quran and the Sunna and the objective circumstances in which man must strive to obey them are divinely ordained.²⁵¹

There is thus a focus on both the divine nature as well as practical aspects of Islamic law. It is therefore argued in this thesis that *Tawhid* being the guiding principle of Islamic law and Jurisprudence can form the outline of what has been called the *Tawhidi* Framework for Islamic finance and economics²⁵², which in essence encapsulates the idea that all economic and finance activity is taken as a religious duty as much as a commercial or business activity²⁵³ and thus all such economic and commercial activity must be in line with the basic principles of Islamic jurisprudence as defined under the *Maqasid* and *Maslaha* ideals.

b. Trusteeship (*khilafah*)

Another unique concept in Islamic teaching which affects traditions in economics and business is that of trusteeship (*khilafah*), which establishes that people are, in essence, considered as trustees of the earth's resources on behalf of God himself.²⁵⁴ This would mean that everything that humans own materialistically is actually the property of God and that man is to use these resources according to the directions of God. In Islamic teaching, trusteeship would also mean the use of resources by man in his capacity as a steward of God, thus allowing the use of the resources according to the teaching of the Qu'ran and the *sunnah* of the Prophet Muhammad.²⁵⁵ From an economic point of view, this can be translated to mean that man is free to use the resources bestowed upon him, as long as there is no conflict between what he does

²⁵¹ Hassanuzzaman (n 180)

²⁵² Naqvi (n 8)

²⁵³ Chapra (n 164)

²⁵⁴ Gillian Rice (n 144)

²⁵⁵ A S Abbadi, *Al-Mal4ah Fai Al-Sharia Al-Islamiah, Maktabah Al-Aqsa(English Translation)* (Vol. 3, Amman. 1977)

and the established Islamic edicts and principles espoused in the Qu'ran and the *sunnah*.²⁵⁶ Consequently, there is no prohibition on owning private property and no restriction of any economic initiative that one may desire to undertake, so long as there is recognition of the fact that prosperity and wealth creation is not an end in itself and is rather just a means towards a better, socio-politically just society.²⁵⁷ Siddiqi is of the view that in Islam, if the intention is correct, then all economic activity can be given the status of worship.²⁵⁸

Another way of looking at the concept of trusteeship is to look at how resources may be disposed of. If it is done justly and fairly so that everyone's interest is safeguarded and taken into account, it is considered the right way according to Islamic edicts and teachings. Islam is against any lavish spending and any wastage of resources; no one is allowed to waste the resources bestowed upon man by God as a trust.²⁵⁹ This concept of anti-conspicuous consumptions and sensible resource allocation has resonance in modern day environmental laws, stakeholder theory, CSR, western and Islamic business ethics as well as many other concepts in their respective corporate laws across the globe. This point shall be further elaborated upon in criticising the neoliberal profit maximizing approach to governance.²⁶⁰ According to Gillian Rice, '[t]rusteeship is akin to the concept of sustainable development', an assertion that is further explored by a study conducted by the UNDP which states that '[m]odels of sustainable development do not regard natural resources as a free good, to be plundered at the free will of any nation, any generation or any individual'.²⁶¹ Thus, it is argued that this concept forms a major

²⁵⁶ Usmani (n 196)

²⁵⁷ Rice (n 144)

²⁵⁸ Siddiqi (n 26)

²⁵⁹ Chapra (n 164)

²⁶⁰ Chapters 6 And 7

²⁶¹ Rice (n 144)

ideological building block for an Islamic financial system both at the macro and micro level and must be taken into account when devising a regulatory and governance framework for Islamic financial institutions.

c. Economic freedom

Whilst Islamic teachings are focused mainly on societal well-being in the socioeconomic sphere, there is nonetheless very strong encouragement of the individual pursuit of economic interests. This individual freedom is backed by the assertion that every individual, according to Islam, is accountable for his actions done in this world.²⁶² One would be rewarded for their good actions and punished for any evil actions in the Hereafter. It is this accountability for individual actions which forms the basis of every Muslim's faith, meaning such accountability is rendered meaningless if the individual is not provided with reasonable freedom to act independently.²⁶³ Thereupon, Islam not only encourages individual freedom in the economic sphere, but makes it mandatory for all able-bodied men and women to carry out economically useful activities. Islam thus places the highest value on an individual's freedom of action in every field of human activity such as social, political, economic, religious and moral acts.

The Islamic principle of economic freedom means that an individual has been allowed the liberty by God to earn wealth, own it, enjoy it and spend it as ordained by Islamic teachings.²⁶⁴ It also allows freedom to adopt any profession, business or vocation to earn a livelihood, as long as these professions do not conflict with the basic moral, social, legal and ethical codes laid down in the Qu'ran and the

²⁶² G Eaton, *Islam And The Destiny Of Man* (The Islamic Texts Society, Cambridge 1994)

²⁶³ Niazi (n 36)

²⁶⁴ Karnali (n 195)

Hadith.²⁶⁵ The biggest restriction on this individual freedom is the conceptual and practical distinction between *halal* (lawful) and *haram* (unlawful) as laid down in the Qu'ran and the *Hadith*.²⁶⁶ In the field of production, distribution, exchange and consumption, only *halal* means are permitted. An individual remaining within the restrictions of *halal* and *haram* can therefore enjoy full freedom to earn and spend wealth as he likes.²⁶⁷ This concept is ideologically antithetical to neoliberal profit maximising norms in the financial and corporate spheres and accordingly would cause systemic governance and operational issues if the Islamic finance industry were to follow neoliberal norms.

Whilst no upper limit or ceiling is imposed on owning properties or holdings or profits, personal wealth is held captive by the compulsory taxation levied on those who can earn in the form of *zakat* (obligatory almsgiving). Besides the restrictions of *halal*, *haram* and *zakat* for Muslims, there is one more major normative constraint, dictating all economic activities (including but not limited to: the pricing of goods, ownership of assets, setting up businesses and curtailing monopolies) are carried out in order to safeguard the common interest of Muslim community and to pursue a common and public good to enhance happiness for the whole of society, an idea that can be traced back to the concept of *Maslahaha*.²⁶⁸ This pursuit of public good (*Maslaha*) and furthering the common interest of the Muslim community renders a conventional regulatory and governance framework incomplete for the purposes of an Islamic finance industry, the argument being that the Islamic finance industry needs to be regulated in a manner involving a principle based regulatory regime

²⁶⁵ Naqvi (n 156)

²⁶⁶ K Ahmad, *Islamic Economic Order* (N.D.), Unpublished Paper

²⁶⁷ Rice (n 144)

²⁶⁸ A Mirakhor, *General Characteristics of An Islamic Economic System*, in A. Siddiqi(Ed), *'Anthology Of Islamic Banking'*, (Institute Of Islamic Banking And Insurance, London 2000). 11-31

which encourages maximum participation and welfare of the maximum number of stakeholders in society.²⁶⁹ The current en vogue conventional regulatory and governance paradigm lacks this particular aim and thus needs to be adjusted to cater for the Islamic financial industry. It is for this reason that an inquiry into the main pillars of the Islamic economic system, along with a consideration of the aims and the objectives (which have already been discussed) of an Islamic economic and financial system, is needed to better understand what principles and outcomes should be expected from a regulatory and governance framework for IFIs and whether those frameworks actually correspond to the *Maqasid al Shariah* and whether they are in line with the larger issue of *Maslaha* (public / common interest) for the society.

4. Fundamental pillars of Islamic business and its economic model

Before we discuss in detail the most important aspects of Islamic economic laws regarding the asset based trading and speculative trading in the next chapters, we also need to discuss the other vital pillars of Islamic economics that play an important role in formulating an Islamic economic system. Based on Islamic teachings and values, the Islamic economic model rests on five other basic pillars (excluding the three mentioned above: ban on interest, asset backed transactions and ban on speculation). First, the concept of property rights. Second, the obligations that derives from contracts and their enforceability. Third, the right to pursue individual economic aims. Fourth, the rules regarding attainment and distribution of wealth and fifth, the rules regarding risk sharing.²⁷⁰ This list of basic pillars is not exhaustive since the basis of Islamic economics and finance is the presence of one

²⁶⁹ M U Chapra, *The Islamic Welfare State And Its Role In The Economy In Studies In Islamic Economics* (International Centre For Research In Islamic Economics, King Abdul-Aziz University, Jeddah And Islamic Foundation, Leicester 1981)

²⁷⁰ M Abdulrauf, *The Islamic Doctrine of Economics and Contemporary Economic Thought*, (American Enterprise Institution For Public Policy Research, Washington D.C. 1979)

main aim (the actual *Maqasid Al Sharia*); the attainment of socioeconomic justice in society through economic activity and any other such concepts that may facilitate that outcome.²⁷¹ However, for the current thesis the five pillars will be discussed in context of how they further the *Maqasid* of attaining the socio economic justice.

These pillars of the Islamic economic system are directly derived from the aforementioned overarching major principles of *tawheed* (unity of God), *adallah* (justice), *khilafah* (trusteeship) and the need for moderation in everything that a Muslim does which determine the practical outcome of the Islamic economic system.²⁷² They are inherently important for both ideological and practical purposes, since without proper understanding these basic principles of Islamic economics and finance, deriving a principle-and-outcome based governance and regulatory framework for IFIs is not possible. The following are the basic pillars of the Islamic economy.

i. Pillar one: property rights

The concept of property in Islamic economic thought is distinct from western economic and legal thought. In essence, western economic and legal thought dictates that property rights are associated with an exclusive right of possession, disposal and ownership of the property to the exclusion of all others.²⁷³ On the other hand, the concept of property rights under Islamic economic thinking (which is derived from the principle of *khilafah*) asserts that Allah is the ultimate owner of all property. Man has simply been given a right of possession and the right to create wealth and sustain himself through labour and utilisation of the property granted to him by God

²⁷¹ T Philipp, 'The Idea Of Islamic Economics' (1990), *Die Welt Des Islam*, New Series, Bd. 30, Nr. 1/4 Pp. 117-139 Published By: BRILL Stable URL: <http://www.jstor.org/stable/1571048> Accessed: 17/09/2010 08:27

²⁷² Iqbal And Mirakhor (n 3)

²⁷³ Wilson (n 228)

in line with the rules laid down in *Sharia*.²⁷⁴ This does not mean that the state or a government has a direct right in the property of an individual,²⁷⁵ but rather the concept is more theological and meant as a religious obligation for man to use the property as directed by *Sharia*.²⁷⁶ As long as man is using property in line with the dictates of *sharia*, man continues to have a right over that property. This can be seen in practice through the application of *zaka* (obligatory wealth tax) on assets which are not being utilised.

There is another aspect of this principle of property, related to the ability of man to derive his share from the common pool of property, granted to him either through transfer and exchange or through his own creative labour.²⁷⁷ In essence, Islamic teachings lay out that work or labour determines an individual's right over property, whether that be a right of possession or simple enjoyment of the benefits accruing from that property. So in sum, all property first belongs to the collective, and then to the individual only once they have either performed some form of work or have inherited the relevant property.²⁷⁸ It can thus be determined that work and labour are a prerequisite for having property rights, ensuring that property remains in use and wealth is circulated rather than hoarded. Otherwise, *zakat* is levied on such property.²⁷⁹

This concept of property and labour is of direct relevance for the Islamic financial industry, since all Islamic financial activity has to be backed by real assets and is based on either a partnership model (*musharakah*), agency model (*mudarabah*) or a sale based transaction (*bay*). Thus, there is either labour or risk involved in an

²⁷⁴ Al-Omar and Abdeel-Haq (n 229)

²⁷⁵ Ghamdi (n 51)

²⁷⁶ Iqbal and Mirrakhor (n 3)

²⁷⁷ Iqbal and Mirrakhor (n 3)

²⁷⁸ Diwany (n 28)

²⁷⁹ R M Moore and N. Delener, *Islam And Work* in G. S. Roukis And P. J. Montana (Eds.), *Workforce Management In The Arabian Peninsula* (Greenwood Press, Westport, CT 1986)

investment that is part of a financial activity.²⁸⁰ The other very important aspects that can be ascertained from the concept of property are the rights of the collective; an economic activity in line with *sharia* has to be carried out for the greater public or common good of society and not only for individual gain.²⁸¹ The individual who takes the risk or performs work on the property takes priority over others with regard to the returns from the investment or work. Before that, the property belongs to the collective.²⁸² This completely conflicts with the neoliberal understanding of property and consequently it is argued that this(the difference in conception of property rights) is one of the main reasons that the shareholder primacy corporate governance model, as well as the profit maximising neoliberal regulatory framework, is ill suited to IFIs.

ii. Pillar two: the obligation deriving from contracts

In Islamic law, the importance of a contractual obligation cannot be overlooked or underestimated. It is probably one of the most strictly adhered to principles in *shariah*, specifically in the context of economic and commercial dealings called *muamalat*.²⁸³ The underlying theme of Islamic teaching regarding contracts is that all freely entered into contracts which have not been expressly prohibited by the *sharia* and which are not repugnant to the teachings of the Qu'ran and *Hadith* are allowed to stand and be enforced by a court of law.²⁸⁴

iii. Pillar three: the right to pursue individual economic aims

²⁸⁰ Iqbal and Mirakhor (n 3)

²⁸¹ Biraima (n 212)

²⁸² Cizakca (n 218)

²⁸³ Al-Omar and Abdeel Haq (n 229)

²⁸⁴ Vogel and Hayes (n 17) , and also discussed previously in chapter 2 of this Thesis

Further deriving from the basic Islamic principle of economic freedom, one can assert that Islamic teachings do not restrict the individual pursuit of economic goals. The caveat is that these goals must be in line with the principles and teachings of *sharia*. The individual's right to pursue economic goals is subsumed within the main body of rights and obligations defined in *sharia*.²⁸⁵ Thus, the individual is first and foremost charged with the obligation that he/she owes to God, nature, other human beings and then to himself.²⁸⁶ Once these obligations are fulfilled the individual is granted certain rights. One such right is the freedom to pursue economic goals within the limits prescribed by *sharia*.²⁸⁷ Only when this hierarchy of rights and obligations are fulfilled can the whole system truly be termed Islamic in letter and spirit.²⁸⁸ However, once the prerequisites of *sharia* are fulfilled the individual's pursuit of economic goals is no longer a right; rather it turns into an obligation that man owes to himself and society as long as they possess the ability and capacity to contribute with labour or capital.²⁸⁹ It can hence be observed that Islamic teachings and ethics are actually pro-commerce and not anti-commerce, as is generally believed. The pursuit of economic interests is actually a part of the faith's whole architecture as well as the socio-economic system under Islamic teaching and correspondingly encourages individuals to pursue economic interests for the welfare of both society and themselves.²⁹⁰

iv. Pillar four: attainment and distribution of wealth

²⁸⁵ Iqbal and Mirakhor (n 3)

²⁸⁶ This Can Be Related To The Stakeholder Theory In Modern Day Corporate Governance Literature. It Is Discussed In Detail In Chapter 7

²⁸⁷ M Kahf, *A Contribution To The Theory Of Consumer Behavior In An Islamic Society In Studies In Islamic Economics*, Ed By K. Ahmad. (International Centre For Research In Islamic Economics, King Abdul-Aziz University, Jeddah And Islamic Foundation, Leicester 1981)

²⁸⁸ Cizakca (n 218)

²⁸⁹ Cizaka (n 218)

²⁹⁰ Ghamdi (n 51)

Another of the pillars of Islamic economics is the concept of wealth and the subsequent use, distribution and disposal of it.²⁹¹ Whilst Islam encourages man to utilise any resources given to him by God in a fair and just manner, the Islamic teachings regarding personal wealth go further in delineating how wealth is to be acquired and disposed of in a way that is beneficial to the individual as well as society.²⁹² Wealth is considered to be a ‘good’ for both the individual and society, as it is prescribed that wealth is to be utilised for the benefit of both society and the community.²⁹³ However, there are very strict requirements that need to be met when earning wealth. For example, what methods can be employed to attain or dispose of this wealth, in what proportions and at what time? Such stringency has led to the highlighting of professions that are not permitted to gain wealth. Even within the professions that are so permitted, the details of how one must conduct their daily business in those professions is also highlighted and categorised as *haram* (not permitted), *halal* (permitted), discouraged but allowed, and recommended and allowed.²⁹⁴ This is probably one of the main features of modern day Islamic finance jurisprudence; Islamic financial institutions have Islamic scholars on their boards (the SSB) that decide whether or not to allow a particular transaction by relying on these principles. The roots of these principles are very well entrenched in *fiqh* (jurisprudence guided both by the Qu’ran and the *Hadith* of the Prophet Muhammad)²⁹⁵ and thus there is very little disagreement regarding these principles amongst the scholars, thus normatively bringing in much needed uniformity in practice and theory.

²⁹¹ Haron (n 10)

²⁹² Haneef (n 58) 39-65

²⁹³ Iqbal and Mirakhor (n 3)

²⁹⁴ Hassanuzzaman (n 180)

²⁹⁵ Philips (n 38)

As discussed above, one very important part of the concept of wealth is that Islamic teachings are abhorrent to wealth being hoarded. Teachings of all schools of thought require that wealth be circulated by mandatory wealth taxes (*zakat*), investments (business activity) or charity. As has been seen, Islam encourages individuals to invest and give freely to the needy to meet this end. This is also one of the reasons why there is a very strict ban on charging usury (*riba*), since Islamic *fiqh* (jurisprudence) has asserted over and over again that usury leads to greed, hoarding and exploitation of the weak; all three go against the core teachings of Islam.²⁹⁶ In summary, the distribution of wealth is the main reason for the ban on *riba* (usury), forming the main stay of the Islamic financial system, and must be made the guiding principle for all stakeholders involved in the industry.

v. Pillar five: risk sharing

Another pillar that derives its validity from the concept of wealth and justice (*adalah*) is risk sharing. This concept holds that a profit in a business transaction is only justified if there is a proportionate risk involved for the profit maker.²⁹⁷ Simply put, this means that one cannot be expected to make profits without there being any liability on his/her behalf.²⁹⁸ This concept forms a very important part of modern day Islamic jurisprudence regarding Islamic finance as all Islamic financial institutions are expected to ensure that they follow this principle whenever they create an economic opportunity. Whether this opportunity is gained through granting a simple loan or entering into a partnership with another entity, the risk is supposed to be

²⁹⁶ Iqbal and Mirakhor (n 3)

²⁹⁷ Iqbal and Mirakhor (n 3)

²⁹⁸ Cizakca (n 218)

proportionate to the profit being derived.²⁹⁹ It follows that scholars like Mulana Taqi Usmani are adamant, on the basis of this entrenched requirement of risk sharing between the parties, when asserting that the Islamic financial industry must move to a more risk sharing based financial system where *mudarabah* (agency contracts) and *musharaka* (pure equity participation contracts) are the main methods of financial intermediation with a corresponding shift away from *murabaha*-based (sale plus mark-up) financial activity, the latter leading to the distortion of risk and returns whilst also going against the basic aims of Islamic economic ideology.³⁰⁰

5. Factors of production in the Islamic economic system.

Islamic finance takes the view that a financial system has to be able to adhere to the principles of distributive equality for it to be *sharia* compliant in both letter and spirit.³⁰¹ In order to establish such a system, there has to be an analysis of what actually contributes to the structure of such a financial system and which factors of production are deemed part of the financial system. Once this is determined, the overall efficacy of the corporate governance and regulatory model can be observed and subsequently scrutinised to determine whether the financial services and products being employed by Islamic financial institutions do in fact adhere to these principles.

Factors of production in Islam can thus be determined while keeping in view the principles and rules regarding the distribution of wealth according to an Islamic business ethos.³⁰² As we have discussed, the distribution of wealth has slightly different connotations in Islamic jurisprudence than in western economic systems

²⁹⁹ This is further discussed in great detail while discussing the financial instruments being used in IFI's in chapter 5 and 6

³⁰⁰ This will be discussed in detail in the 5th and the 6th chapters

³⁰¹ Usmani (n 196)

³⁰² Usmani (n 196)

(both the pure capitalistic, neoliberal economic system and the more archaic socialist economic system).³⁰³ According to the Islamic traditions of distributive justice, there are two categories of subjects that must benefit from the distribution of wealth which may accrue from any economic activity both at the macro (state level) and the micro (individual or business level). These two categories are divided not only according to how much one contributes, but rather on pre-designated edicts espoused by the Qu'ran and the teaching of the Prophet Muhammad. Clearly, western and Islamic economic philosophy can be distinguished.³⁰⁴ Western economic philosophy (primarily, neoliberal pure capitalistic philosophy) only recognises those factors of production which contribute in economic or commercial terms, which means that particular segments of society with no intrinsic economic value are either not recognised in the overall balance sheet, or are recognized but disregarded because of their inability to contribute to the overall value by adding to the productivity of society.³⁰⁵ Consequently, people or 'assets' which have nothing to contribute economically are given no returns and are not a part of the wealth distribution mechanism.

Adam Smith, the father of modern day capitalism and materialistic economics, called capitalism 'the obvious and simple system of natural liberty',³⁰⁶ which leads to the misnomer that an individual has the right to own private property and can pursue self-interest. Thus, the factors of production in capitalism can be divided into four categories: capital, land, labour and the entrepreneur.³⁰⁷

³⁰³ A A Hanafy and H Sallam 'Business Ethics: An Islamic Perspective' (1988) Proceedings Of The Seminar On Islamic Principles Of Organizational Behavior (International Institute Of Islamic Thought, Herndon, VA)

³⁰⁴ S A Ali, *Economic Foundations of Islam* (Calcutta: Orient Longmans, 1964), 174

³⁰⁵ Usmani (n 196)

³⁰⁶ Adam Smith, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations* (1776)

³⁰⁷ M Blaug, *Economic Theory in Retrospect* (Cambridge: Cambridge University Press, 1978)

All of these factors have different meanings than they have in Islam and the fourth is not included at all in Islamic ethos.³⁰⁸ In capitalism, the entrepreneur is responsible for bringing together all of the other factors for the production and generation of wealth. He also has the right to own property and accumulate wealth in his hands. The emphasis is therefore on individualistic wealth creation and profit making through the 'invisible hand of the market forces', rather than allowing state power (society's authority) to ensure a more equitable distribution of wealth.³⁰⁹ However, as we have observed previously, the Islamic conception of economics, wealth and property is very different from a materialistic understanding of these concepts.

According to Islam, the real wealth of societies lies with their people in general and not any one segment of society, whereas this is precisely the case in most neoliberal pure capitalistic societies like the USA, where almost 80 percent of the wealth is concentrated in the hands of the top 5 percent of individuals.³¹⁰

This leads to the unequal distribution of wealth and breeds discontent, leaving the fate of the less fortunate in the hands of those who hold the reigns of political and economic power rather than allowing the state to contribute towards helping the needier segments of society. An excessive obsession with the creation of material wealth can also obscure the ultimate objective of enriching human lives and as a result, humans are the ends as well as the means.³¹¹ Unless humans are motivated to pursue their self-interest within the constraints of economic well-being (the

³⁰⁸ Usmani (n 196)

³⁰⁹ The term was coined by Adam Smith in his 1776 book "an inquiry into the nature and causes of the wealth of nations"

³¹⁰ Usmani (n 196)

³¹¹ Hassanu-Zaman, *The Economic Functions Of The Early Islamic State* (International Islamic Publisher, Karachi 1981)

application of the ‘moral filter’), neither the ‘invisible hand’ of the market nor the ‘visible hand’ of central planning can succeed in achieving socioeconomic goals.³¹²

In fact, the profound and far-reaching difference between Islamic economics and materialistic economics is simply this: according to materialistic economics ‘livelihood is the fundamental problem of man and economic developments are the ultimate end of human life’ whereas according to Islamic economics “livelihood may be necessary and indispensable, but cannot be the true purpose of human life’.³¹³

In an Islamic based distributive justice system, economic well-being thus becomes merely one of the aims of human endeavour and not the ultimate aim. This is reflected in the way Islamic economics views its factors of production.³¹⁴ In simpler terms, it can be argued that Islamic economic and business philosophy functions on the understanding that the end goal is the achievement of a common good which can be determined not only through economic goals and targets, but through how well economic and business activity in general augments the overall welfare of the society (a concept discussed in detail previously).³¹⁵

There are two broad categories for factors of production in Islamic economic philosophy.³¹⁶ The first includes factors which can be said to have a primary right by virtue of having directly taken part in wealth production. These factors are then further divided into capital, (means of production which are fully consumed in the production process such as cash and other liquid items) land (means of production

³¹² Chapra (n 164)

³¹³ Usmani (n 196)

³¹⁴ Mannan (n 217)

³¹⁵ A Mawdudi, *Economic System Of Islam*(Islamic Publication, Lahore 1984)

³¹⁶ Usmani (n 196)

which remain unaltered even after passing through the production process, such as buildings or factories) and labour (the human exertion of force by hand or mind).³¹⁷

The second category includes factors that can be said to have a secondary right, having had no direct part in wealth production but are nonetheless entitled because of the Islamic conception of wealth sharing; everything belongs to Allah and must be shared and given in the way of Allah.³¹⁸ If these two factors of production are combined, they form a perfect, harmonious economic system. This is in contrast to pure socialism, where there is incentive for individuals to pursue their own economic goals (albeit within certain moral and ethical confines) and reward for labour and contribution towards an enterprise despite there being no pursuit of blind profit maximisation in addition to no social contribution towards society as a whole (as is the case in the neoliberal pure capitalistic movement).³¹⁹ The Islamic system therefore provides all segments of society a conduit to greater access to resources and thus allows for a proper stakeholder oriented financial system.³²⁰

Comparatively, under classical socialist economic theory only one factor of production is recognised: labour.³²¹ All other factors are considered to be equally and collectively owned at the national level. Hence, the question of private ownership and right to profits (and wealth) does not lie with one individual, but rather the whole nation as one.³²² This means that there is no incentive for any individual endeavours or pursuits, leaving the economic system stagnant.

³¹⁷ F Pryor 'The Islamic Economic System' (1985) *Journal Of Comparative Economics*, Vol.9,197-223

³¹⁸ Pryor (n 299)

³¹⁹ M M Shafi, *Distribution Of Wealth In Islam* (B. Aisha, Karachi 1975)

³²⁰ R Wilson, *Business Ethics: Western And Islamic Perspectives* in K Ahmed and A M Sadeq, *Ethics In Business And Management: Islamic And Mainstream Approach* (Asean Academic Press, London 2001)

³²¹ R J Saint, *An Essay On Marxian Economics* (Martin's Press, New York 1947)

³²² F Taylor 'What Is Socialism?' (2013) *Journal Of Socialist Theory* 40 :27

According to Chapra, Islamic business and economic thinking recognises what socialism did not:

The contribution of individual endeavour and the ability to earn a profit through that endeavour, everything was determined by the state without any differentiation between the actual output of individuals, creating a disincentive for those with more abilities and capital (both human and pecuniary) there by eliminating any chances of innovation, efficiency and enterprise. Islamic economics on the other hand encourages the individual enterprise for the sake of both the individual as well as the society. At the same time, Islam condemns the evils of greed, unscrupulousness and disregard for the rights and needs of others, which the secularist, short-term, this-worldly perspective of capitalism sometimes encourages.³²³

The ethos of an Islamic economic and business system therefore treads the ‘middle path’, where the individual profit motive is not the chief propelling force, with socioeconomic good also normatively guiding entrepreneurs in their decisions, without profit being deemed the only plausible end.³²⁴ At the same time, the Islamic economic system does not completely negate the individuality of man like the socialist system, instead creating a hierarchy between the different strata of society that makes the collective more important than an individual in the context of the distribution of resources.³²⁵

³²³ Chapra (n 164)

³²⁴ Siddiqui (n 26)

³²⁵ S M H Zaman, *Economic Functions Of An Islamic State: The Early Experience* (The Islamic Foundation, Leicester 1991)

When it comes to economic freedoms and rights, Islam places a greater emphasis on duties than on rights.³²⁶ The wisdom behind this is that if duties (relating to justice and trusteeship, for example) are fulfilled by everyone, then self-interest is automatically held within boundaries and the rights of all are undoubtedly safeguarded.³²⁷ It is said that '[s]ociety is the primary institution in Islam, not the state',³²⁸ further strengthening the argument that a regulatory framework designed for institutions handling Islamic finance must be based on a business model which encompasses its ethical norms and aims to achieve a common or public good through ensuring distributive justice for adherents of the system. This argument could further be used to argue in favour of the establishment of a self-regulating framework for IFIs in countries which do not recognise *sharia* as a valid source of law. This would allow local IFIs and the Muslim community (scholars, customers, and banking experts) to work in conjunction with the guidelines laid down by the IFSB and AAOIFI to determine a result-oriented regulatory framework which fulfils all the religious and governance requirements of Islamic finance keeping in view the issue of *Maslaha* as a guiding principle. Chapra further argues that 'in order to create equilibrium between scarce resources and the claims on them in a way that realises both efficiency and equity, it is necessary to focus on human beings themselves, rather than on the market or the state.'³²⁹ Thus, an economic system which caters to as many categories of stakeholders as practicable can embody a true Islamic economic and business ethos. Consequently, the aim of the regulators should

³²⁶ F Khan, *Islamic Banking As Practiced Now In The World, In Money And Banking In Islam* (International Centre For Research In Islamic Economics, King Abdul Aziz University, Jeddah And Institute Of Policy Studies, Islamabad 1983)

³²⁷ S Qutub, 'Social Justice In Islam', in A. Khurshid (Ed.), *Islam Its Meaning And Message* (The Islamic Foundation, Leicester 1980)

³²⁸ L J Cantori and A Lowrie, 'Islam, Democracy, The State, And The West' (1992) *Middle East Policy*, Vol. 1, No. 3, 49-61

³²⁹ Chapra (n 164)

be to ensure the development of a true stakeholder-oriented regulatory framework which can facilitate the operations of the Islamic financial industry and which is successively in line with the *Maqasid al sharia*.

It is therefore argued that since neither neoliberal nor Anglo-American corporate governance models can satisfy the ethical and jurisprudential requirements for institutions handling Islamic financial instruments, there is a dire need to rethink the whole regulatory mechanism in place in Islamic and non-Islamic countries alike.³³⁰ The regulatory mechanism, as will be argued in the final chapter of this thesis, needs to be modified to ensure that it specifically caters to the stakeholder-oriented nature of the Islamic financial industry within those jurisdictions which allow IFI's to operate as an alternative financial intermediary to conventional financial institutions.

6. The Islamic moral economy and its effects on Islamic financial industry.

It has also been argued that the specific categorization of the *Halal* and *haram* and the surrounding ideological debate along with the substantive prohibitions of *Riba* and *Gharar* as well as the tenets of contract law and business ethics principles can be well amalgamated and are indeed reflected in the Islamic moral economic framework as suggested by Mehmud Asutay.³³¹ The Islamic moral economic framework argument as put forward by Mehmud Asutay, predicates on the argument that the Islamic financial industry is a sub set of the overall Islamic economic

³³⁰ The Islamic states and non-Islamic states can be categorised as countries where islam is the state religion and the laws and regulations are made and applied in line with sharia as in Pakistan, Iran and Sudan or in countries where there is a majority of Muslim population but the state does not enforce religion as an obligation like in turkey, Jordan, Egypt, Tunisia Algeria, Kuwait but still recognizes sharia as a sources of law can be categorised as Islamic countries, and countries where the Muslims are in a minority(albeit in a sizeable minority) and neither the legislature nor the judiciary accepts sharia as a valid sources of law can be categorised as non-Islamic countries like the states In EU And The USA.

³³¹ M Asutay ' Conceptualising and Locating the Social failure of Islamic finance: aspiration of Islamic moral economy vs the Realities of Islamic finance' (2012)., Asian and African area Studies, 11(2):93-113

framework, and should emulate the ethos of Islamic moral economy.³³² It is thus argued in this thesis that despite being extremely important and relevant, the Islamic moral economic framework can only be properly followed and adapted in a perfect situation where there is an endeavor at the state or the jurisdiction level to adapt the Islamic economic model by legal mechanisms, for example in countries like Pakistan, Iran and Saudi Arabia, where the states have declared Islam as the state religion of the country and thus the state apparatuses like the Judiciary and the legislature as well as the central bank and/ or financial regulators are able to understand and formulate such laws which allow the economic framework to be adapted to Islamic law and ethos. However in more secular jurisdictions, arguing for a macro level economic shift to an Islamic moral economy may not be practical or indeed possible. It is in light of this practical and conceptual difficulty of amalgamating Islamic moral economy with a secular legal and economic system, that it is thus argued that Islamic financial institution are better suited to follow a more stakeholder oriented (which in essence does reflect the Islamic moral economy principles) governance mechanism which has an established presence in other jurisdictions like the USA, UK and the EU countries and at the same time it embodies some of the most important ethical and business practices of the Islamic economic model and thus augers well for the normative ideals that IFI's would want to incorporate in their working at both the macro level as well as micro levels.

7. Conclusion

Having ascertained the basic principles and pillars of Islamic economics, law, business ethics and finance from both traditional as well as contemporary literature, and having established that Islamic economic and finance norms are very different

³³² M Asutay ' Political economy approach to Islamic Economics: Systemic Understanding for an Alternative Economic System' (2007), Kyoto Bulletin of Islamic Area studies, 1-2, 3-18

from the norms of neoliberal profit maximising theories and practices, this chapter lays the ground work for the rest of the thesis to be moulded around the important aspects of Islamic economic principles. It is therefore asserted, basing on the basic principles and norms of the Islamic economic system ,that a regulatory and governance framework based on the ideological foundation of neoliberal theories is ill-suited for the Islamic finance industry. To establish a fitting governance and regulatory framework would require concentration on the basic principles and ideological foundations (the *Maqasid al Sharia*) of Islamic finance and economics both at the macro level (international as well as national standard setting bodies and regulators) and the micro level (the industry and the individual). Accordingly, it shall be argued in the next chapters that a thorough knowledge of the basic principles of Islamic finance would allow policy makers to solve specific corporate governance and regulatory issues that the modern Islamic finance industry is facing or may potentially face because of being regulated and governed under the same regimes as conventional banks and corporations. These regimes are unable to cater for the specific requirements of the Islamic finance industry. It follows that a move towards a more tailored governance and regulatory framework needs to be undertaken if Islamic finance is to remain true to its ideology and principles. For this purpose, a principle-and-outcome based regulatory framework needs to be devised which is meta-regulatory in nature.

CHAPTER 4. WESTERN CORPORATE GOVERNANCE THEORY: THE PROFIT MAXIMISATION PROBLEM

1 Introduction

Having established the basic parameters of Islamic financial architecture in the previous chapters, we will now examine the effects of traditional neoliberal corporate governance theory on the working of IFIs and how the contemporary corporate governance theory is indeed ideologically incompatible with Islamic finance principles. This chapter will deal with the fundamentals values of the neoliberal shareholder primacy theory by extrapolating the historical as well as economic development of the Neo liberal ideals. This chapter shall also establish that, due to the ideological contrast of the Islamic finance literature and neoliberal corporate governance theory, any endeavour to govern or regulate the Islamic finance industry by the principles and practices espoused by the neoliberal theory will create systemic problems for IFIs. The major aim of this chapter is to try to establish a lack of synergy between the traditional theories of Islamic finance/commerce and the more modern corporate governance theories in their present forms following the famous Berle and Means restatement of corporate/managerial theory in ‘The Modern Corporation and Private Property’.³³³ The discussion will centre on deciphering the similarities and differences between the neoliberal corporate governance theory, and the principles and rules derived from Islamic finance literature in the previous two chapters.

³³³ A A Berle Jr and G C Means, *The Modern Corporation And Private Property* (New York: Macmillan 1932)

2. Ownership and control: a historical perspective of the twenty first century corporation

The rise of the large public corporation in the late 19th century spurred a debate surrounding the legitimacy of a new form of legal entity called the corporation, with dispersed freely transferable shares, limited liability for investors (shareholders) and a separate legal identity from its owners (investors).³³⁴ The initial debate surrounding this new legal mechanism in the early 18th century was predominantly concerned with the fundamental concepts of a limited liability incorporated legal entity, how it functioned and how the state was expected to control it. In light of scepticism surrounding the corporate form, the governments and judiciaries of both the UK³³⁵ and the USA pondered uncertainly over the best methods of keeping such corporations in check, resulting in a debate regarding the most suitable methods of regulating and governing the modern day corporation. One contemporary issue was the reconceptualization of the ‘share’ as a tradable commodity from a simple ‘joint stake’ (stock) in a partnership. This reconceptualization led to the confusion surrounding the ‘shareholders’ as the joint ‘owners’ of a company,³³⁶ leading in turn to further confusion surrounding the legal status of the ‘share’ itself as a property right in the company³³⁷. This meant that the concept of limited liability and a business existing as a separate legal entity seemed inconsistent to the en vogue norms to many academics and practitioners of the early eighteenth century because historically, members of a business partnership were always jointly and severally liable for the entire debt of the business and not just for their own investments.³³⁸

³³⁴ L E Talbot, *Critical Company Law* (Routledge- Cavendish, UK. 2008)

³³⁵ A B DuBois, *The English Business Company After The Bubble Act 1720-1800* As Quoted In L E Talbot *Critical Company Law* (n 314) 50

³³⁶ Talbot (n 314)

³³⁷ *Bligh vs Brent (1837)* 2 Y&C 268

³³⁸ Talbot (n 314)

The above uncertainties led to a contemporary problem which formed the basis of modern day corporate governance debates, the effects of which have resonated globally in the corporate sphere. The problem faced by the legal and business community fundamentally was the confusion in defining the managements' relationships with shareholders and subsequently with the company.³³⁹ This ambiguity emanated from the dually misunderstood conceptualisation of shareholders as the owners of a company (as the main equity contributors), and managers as trustees to the shareholders and not the company itself.³⁴⁰ From a corporate governance point of view, a source of confusion is that managers have historically been thought to be the trustees for the shareholders acting as a collective.³⁴¹ This conceptual misunderstanding, like many others, has historical roots. This particular relationship was borrowed from the law of trusts, as this was thought to be the most convenient method of defining the relationship between the company and the management. This paradigm of managers as trustees for shareholders is still prevalent in modern company law³⁴² and has had a lasting effect on corporate (governance) theory, despite innovative restrictions by both legislatures and judiciaries. This is evidenced by the fact that directors of a company (as a part of the management) still owe a fiduciary duty to the company (which is a historical remnant of the initial trustee relationship).³⁴³ Unfortunately, these sources of confusion have been dealt with haphazardly throughout the 19th and early 20th

³³⁹ Berle and Means (n 313)

³⁴⁰ Talbot (n 314)

³⁴¹ M Dodd 'For Whom Are Managers Trustees?' (1931-1932) 45 HarvL 1162: Judicially Emphasised In The Cases Of *Foss V Harbottle* 1843 2 Hare 461, Which Gave Rise To The 'Majority Rule'. And The Case Of *Percival Vs Wright* (1902) 2Ch 421

³⁴² The fiduciary nature of the relationship is a testament to that confusion

³⁴³ Sec 170 CA 2006 which is a statutory statement of the case of and the case of *Percival vs Wright* (1902) 2ch 421, which laid down that directors owe a fiduciary duty to the company, but not to individual shareholders and individual creditors.

centuries, due to the judiciary³⁴⁴ and the legislature responding in piecemeal fashion to problems as and when they arose, rather than proactively determining the conceptual parameters of corporate theory. This has led to many ‘phantom’ concepts lingering in today’s Anglo-American corporate governance debates.³⁴⁵ Consequently, Anglo-US law and theory seem to represent that the best manifestation of the manager/company/shareholder relationship is to be found in the neoliberal oriented ‘agency theory’.³⁴⁶ This can be seen in the numerous attempts made by international and national standard setting and regulatory bodies to define ‘corporate governance’.

These definitions outline the kind of confusions that still plague today’s corporate governance debates. In setting out the theme of the modern day corporate governance debate, the World Bank’s contextual definition states that: ‘[c]orporate governance has only recently emerged as a discipline in its own rights, although the strands of political economy it embraces stretch back through centuries’.³⁴⁷

One of the major contributors, and an industry leader in the UK in the sphere of business and corporate governance, has said that:

Governance is a word with a pedigree that dates back to Chaucer and in his day the word carried with it the connotation wise and responsible, which is appropriate. It means either the action of governing or the method of governing and it is in the latter sense it is used with reference to companies....A quotation which is worth keeping in mind in this context is: “[h]e that governs sits quietly at the stern and scarce is

³⁴⁴ P Ireland, Grigg-Spall, and D Kelly , *The Conceptual Foundation Of Modern Company Law*, in L.E Talbot (n 314) 44

³⁴⁵ Talbot (n 314)

³⁴⁶ Which itself can be traced back to the separation thesis as espoused by Berle and Means In their seminal work: ‘The Modern Corporation And Private Property’ A A Berle and G.C Means, 1932 New York: Macmillan.

³⁴⁷ World Bank, *Corporate Governance: A Framework For Implementation* (Washington: World Bank 2000)

seen to stir.” It appeals to me because it suggests that governance need not be heavy-handed. The governor should be able to keep the corporate ship on course with a minimum use of the tiller.³⁴⁸

The definition offered in the UK Report of the Committee on the Financial Aspects of Corporate Governance, whilst possessing the advantage of brevity, leaves a lot to be desired: '[c]orporate governance is the system by which companies are directed and controlled.'³⁴⁹

The Organisation for Economic Cooperation and Development (OECD) defines corporate governance with reference to the objectives of a corporation:

[C]orporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performances.³⁵⁰

Furthermore, in 2004 OECD defined good corporate governance as:

[P]rovid[ing] proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the functioning of a market economy. As

³⁴⁸ A Cadbury, *Corporate Governance And Chairmanship*, (Oxford: Oxford University Press 2002)

³⁴⁹ A Cadbury, *Report on the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co. 1992)

³⁵⁰ OECD, *Principles Of Corporate Governance*, (Paris: OECD 1999)

a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.³⁵¹

So in essence, we can say that the institution of governance provides a framework within which the social and economic life of all corporations is included and should not be taken in a narrow sense. Companies that follow good corporate governance practices generally perform better in both the short and long-term, enjoy a larger customer base, are more responsible in the community that they operate in and tend to have a loyal base of employees and suppliers. However, this is all dependent upon which form of corporate governance the company adheres to. On the one hand, if it is focused on a shareholder/profit maximisation approach, then there is a chance that the company is more attuned towards ‘short termism’.³⁵² Whilst on the other, if the corporation is oriented towards stakeholders and social responsibility, shareholder satisfaction may be put at risk because of the apparent neglecting of short-term benefits in favour of the long-term benefits associated with other stakeholders (such as employees), the society, their customer base, using materials that are responsibly sourced and taking care of the environment.³⁵³

Another way to understand corporate governance is that it is not - and should not be - limited to the concerns of the firm. Rather, it has wider implications for society at large insofar as it provides incentive and performance measures to achieve business success (i.e. it can act as a bench mark against which the economic success is measured).³⁵⁴ It also provides the necessary accountability and transparency to ensure an equitable distribution of the resulting wealth, which can be indicative of a

³⁵¹ OECD, *Principles Of Corporate Governance* (Paris: OECD 2004a)

³⁵² S Grossman and O Hart ‘The Costs And Benefits Of Ownership: A Theory Of Vertical And Lateral Integration.’ (1986). *Journal Of Political Economy* 94 (4), 691-718

³⁵³ This will be discussed in more detail in The 6th And The 7th Chapters when we discuss in detail the stakeholder, CSR and business ethics theories

³⁵⁴ H Demsetz, and B Villalonga ‘Ownership Structure and Corporate Performance.’ (2001) *Journal Of Corporate Finance* 7(3), 209-233

healthy economic system and a great indicator for the effectiveness and efficiency of the state's economic and social policies.³⁵⁵ According to Sir Adrian Cadbury: 'corporate governance is concerned with holding the balance between economic and social goals and also between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society.'³⁵⁶

Hence, it can be seen that the conceptual understanding of corporate governance has more to do with internal and external corporate relationships and the subsequent designation of those responsible for doing so. Additionally, it lays down the limitations and extent of the management's powers, as well as the rights and obligation of other stakeholders.³⁵⁷ The current corporate governance theory therefore takes the form of a multitude of concepts in attempting to explain what a company is, what is the role of shareholders, and what are the managers' main duties. As regards the latter, are duties owed only to the shareholders, or may other stakeholders have rights in the company? If so, what kind of rights, how should the corporation best be regulated, who should regulate it, what is the legal standing of a 'share', what does holding a share entail and what rights are attached to it?³⁵⁸ These

³⁵⁵ R Davies, *The Business Community: Social Responsibility and Corporate Values* in. J. H. Dunning, *Making Globalization Good: The Moral Challenge Of Global Capitalism* (Oxford University Press, Oxford 2003)

³⁵⁶ Cadbury (n 329)

³⁵⁷ R E Freeman, *Strategic Management: A Stakeholder Approach* (Cambridge University Press 1984)

³⁵⁸ The Literature On Corporate Governance Regarding These Specific Issues Is Vast And Thus Its Not Possible To Discuss The Whole Field Of Literature Here, However Some Of The Most Important And Influential Work That Has Formed The Basis Of Modern Day Corporate Governance Debate/ Literature Are: L Bebchuk, 'The Case For Increasing Shareholder Power' (January 2005) Harvard Law Review, Vol 118, Pp 833-917,. M C. Jensen And W H Meckling, 'Theory Of The Firm: Managerial Behavior, Agency Cost And Ownership Structure' (1976) Journal Of Financial Economics (JFE), Vol. 3, No. 4., Available At SSRN: [Http://Ssrn.Com/Abstract=94043](http://Ssrn.Com/Abstract=94043) Or Doi: 10.2139/SSrn.94043. M C. Jensen, 'Separation Of Ownership And Control' (1983) Journal Of Law And Economics, Vol. 26 ; D Votaw *Modern Corporations* (Englewood Cliffs, New Jersey : Prentice-Hall, 1965) ; A Chandler, *The Visible Hand*. (Cambridge: Harvard University Press 1977) ; E F Fama, 'Agency Problems And The Theory Of The Firm' (1980) Journal Of Political Economy Vol.88; L Bebchuk, A Cohen, Alma And Ferrell, Allen 'What Matters In Corporate Governance?' (September 1, 2004) Review Of Financial Studies, Vol. 22, No. 2, Pp. 783-827, February 2009; K.M. Eisenhardt 'Agency Theory: An Assessment And Review'. (1989), Academy Of Management Review, 14: 57-74 ; R Morck "A History Of Corporate Governance Around The World", (2007) NBER,

are some of the main points that need to be dealt with in a corporate governance debate, since it may provide an explanation of the unsuitability of the Anglo American corporate governance model – ideologically and conceptually – to the basic ethos(the *Maqasid*) of the Islamic finance industry. This may also clarify why contemporary (and less orthodox) corporate governance models based on stakeholder theory and CSR initially started as viable and sensible concepts but were soon pushed aside by the more dominant neoliberal free market political movement, which gained hegemony over both the theory and practice of corporate governance.

3. Berle and Means and ‘corporate power and control’: an evolutionary Corporate Governance view

By the time of the great depression in the USA in the 1930s, the limited liability corporation had established a firm foothold in the business world, annals of judicial thinking, legislative acumen and a respectable presence in academia. It was this rampant use of the limited liability corporate form for business during the great depression that led to a revival of the aforementioned scepticism in the minds of

Chicago; Fligstein and Choo ‘Law And Corporate Governance’ (2005) Department Of Sociology, University Of California, Berkeley, California 94720, *Annu. Rev. Law Soc. Sci.* 1:61–84; S Bainbridge, ‘The Politics Of Corporate Governance’ (1995) 18 *Harv. J.L. & Pub Pol’y* 671, 674; K Pistor And C J. Milhaupt ‘Law And Capitalism: What Corporate Governance Crisis Reveal About Legal Systems And Economic Development Around The World’ The University Of Chicago Press, Pp.47–68; R Gilson ‘Corporate Governance And Economic Efficiency: When Do Institutions Matter?’ 74 *Wash. U.L.Q.* 327, 331 (1996); M Roe, *Political Determinants Of Corporate Governance: Political Context, Corporate Impact* (Oup 2006) B Cheffins, *Corporate Ownership And Control: British Business Transformed* (OUP 2008); Mark J. Roe ‘*Chaos And Evolution In Law And Economics*’, (1996) 109 *Harvard Law Review* 641, 644–46, 653–60 ; J Coffee ‘The Future As History: Prospectus Of Global Convergence In Corporate Governance And Its Implications’ (1999) 93 *North Western University Law Review*, 641, 646–47; M Roe, *Strong Manager, Weak Owners: The Political Roots Of American Corporate Finance* (Princeton University Press (1994); Lipton and Rosenblum ‘A New System Of Corporate Governance: The Quinquennial Election Of Directors’(1991) 58 *Univ Of Chicago L Rev* 187, 218-19 ; B Cheffins, *Law As Bedrock: The Foundations Of An Economy Dominated By Widely Held Public Companies* (OUP 2003); Hansmann and Karaakman, *The End Of History For Corporate Law* (2000) Yale Law School, Law And Economics Working Paper No. 235/NYU Center For Law And Business, Law And Economics Working Paper No 013, 12-13; B Cheffins ‘Law, Economics And The Uk’s System Of Corporate Governance: Lessons From History’ (2001) *Journal Of Corporate Law Studies*, Vol. 1, No. 1

policymakers.³⁵⁹ However this time, the scepticism had a different focus: the debate was not related to the usefulness of the corporation as a method of investment (indeed, there was agreement both in academia and more generally that it did indeed facilitate investment, help to spread wealth and risk, and provide alternative forms of investment).³⁶⁰ Rather, the scepticism was focused on the problem of controlling the corporations without losing investment attraction. This resulted in serious questions surrounding the control of the management of companies and the subsequent loss of control of the actual ‘owners’: the shareholders.³⁶¹ Thus, the modern day corporate governance debate began.

Historically, one can trace that the means of production in the United States economy of the 1900s were highly concentrated in the hands of the largest 200 corporations. However, at the end of 1929, only 11 percent of the 200 largest corporations in the United States were still controlled by incumbents with much reduced ownership interest.³⁶² Adolph Berle and Gardiner Means in their seminal work on the United States corporate economy, ‘The Modern Corporation and Private Property’, identified an increasing trend towards separation of ownership and control in modern publicly held giant corporations.³⁶³ They recognised an extensive concentration of economic power in large corporations and the shift in control of these corporations had moved from shareholders to managers. Further, they argued that large industrial economies ultimately produced ‘a fragmentation of shareholding

³⁵⁹ Embodied in the policies enacted in the ‘new deal’ by the then president of the USA Frank.D.Roselvelt.

³⁶⁰ A Etzioni, *The New Golden Rule. Community And Morality In A Democratic Society* (New York: Basic Books 1996)

³⁶¹ E Fama ‘Agency Problems and The Theory Of The Firm’ (1980) *Journal Of Political Economy* 88,288-307; and E Fama and M C Jensen ‘Separation of Ownership and Control.’ (1983) *Journal of Law and Economics* 26,301-326

³⁶² Berle and Means (n 313)

³⁶³ Berle and Means (n 313)

and a shift in power from shareholders to senior managers with specialized skills.³⁶⁴

This shift developed because of the increasing technological needs of large corporations, which necessitated the raising of capital by selling stock to vastly dispersed shareholders.³⁶⁵

Since the American legal doctrine provided that those who owned ‘property’ possessed the rights and power to use it for their own benefit, Berle and Means’ separation thesis called into question the functioning of the legal system upon which the private enterprise economies have been built. Further, they pointed out that corporate enterprises - in addition to having become free from the control of corporate owners - had also acquired sufficient power to become liberated from the market forces of competition as well.³⁶⁶ They concluded that much of the economic theory pertaining to the functioning of the marketplace, which served as a rationale for the free enterprise market economy, had been rendered obsolete by the accumulation of immense power in the hands of corporate managers with very broad discretion.³⁶⁷ This provocative thesis generated ongoing debate among economists and legal realists as well as within various institutional frameworks.

The technological advancement during the late 19th century required the construction of transcontinental railroads which far exceeded the capital means of any single individual.³⁶⁸ Thus, railroad companies were compelled to raise capital through a large number of small shareholders and needed to hire specialised officers to manage their far-reaching operations. Due to the scattered nature of small

³⁶⁴ Berle and Means (n 313)

³⁶⁵ Berle and Means (n 313)

³⁶⁶ Berle and Means (n 313)

³⁶⁷ Berle and Means (n 313)

³⁶⁸ Prof L.E.Mitchelle, *The Speculation Economy: How Finance Triumphed Over Industry* (Berrette-Koehlere Publications. USA 2008)

individual investors, power over corporate affairs shifted to management.³⁶⁹ The process of decreasing block holding and the subsequent relatively little block holding in today's United States economy has had important consequences for corporate governance in the Anglo-American context. At present, the corporate governance structure in the Anglo-American model allows shareholders to elect directors, who are made responsible with managing the affairs of the corporation.³⁷⁰ However, the directors delegate their authority to managers, who actually operate and manage the corporation. The only functional powers that the shareholders retain in the contemporary Anglo-American corporate governance regime is the right to vote to elect members of the board of directors and to approve certain fundamental transactions like mergers or sale of corporate assets through that vote.³⁷¹ This has changed significantly with the rise of the institutional investor, but shareholders remain powerless in the current governance architecture, with actual power lying with the management and thus raising serious governance concerns.

It was Berle and Means' thesis³⁷² that prompted the polarisation of opinion regarding the social and economic role of the contemporary firm.³⁷³ Berle and Means were of the view that because of the dispersed nature of modern shareholders and the powers of the modern manager, it followed that managers' powers to use the firm to further their own interests must be controlled. It was this anxiety surrounding management

³⁶⁹ M Jensen and W Meckling 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure.' (1976). *Journal Of Financial Economics* 3, 305-360

³⁷⁰ M Jensen and K Murphy 'Performance Pay and Top-Management Incentives.' (1990) *Journal Of Political Economy* 98, 225-264

³⁷¹ T Clarke (ed), *Theories Of Corporate Governance: The Philosophical Foundations Of Corporate Governance* (Routledge UK 2004)

³⁷² Berle and Means (n 313)

³⁷³ Their views differed in how to get through the depression but the important view that shareholder value was not the sole goal of corporate activity was fairly well agreed upon. In today's shareholder value context, Berle's (n 313) assessment of lack of management accountability, is the starting point on corporate governance discussion- this we might call early Berle and does not properly represent his mature views in modern corporation and after.

power that prompted Berle and Means to assert that ownership and control no longer rest in the same hands,³⁷⁴ and this is what lies at the heart of the mainstream corporate governance debate today. Berle and Means' assertion that the managerial hegemony should not become absolute paved the way for the stakeholder point of view and the socially responsible corporation.³⁷⁵ Here, the corporate governance debate divided into two main themes based upon the separation thesis.³⁷⁶ Firstly, it was stated that the best way to control the corporation is to make the management responsible to the shareholders only - thus arose the shareholder primacy argument (a correlated theory being the agency theory).³⁷⁷ The justification of such a move was that shareholders ought to be considered primarily because they are 'residual owners' of the corporation's assets and also because shareholders - being the least protected out of all the stakeholders³⁷⁸ - need protection and empowerment in the company. This view has persisted and thrived in neoliberal political ideology,³⁷⁹ with emphasis on allowing the corporation to be regulated through pure market forces and a focus on profit maximisation by the corporation in the shape of increased shareholder value.³⁸⁰ This ascendancy of neoliberal free market profit maximising ideals have led to waves of deregulation and has allowed the corporation to hijack whole economies and act irresponsibly by focusing on purely profit maximisation taking unnecessary risks, leading to systemic failures.³⁸¹

³⁷⁴ Berle and Means (n 313)

³⁷⁵ Dodd (n 321)

³⁷⁶ M C Jensen 'Separation Of Ownership And Control', *Foundations Of Organizational Strategy*, Harvard University Press, 1998, And *Journal Of Law And Economics*, Vol. 26, June 1983

³⁷⁷ Fama and Jensen (n 342)

³⁷⁸ H Demsetz 'The Theory of The Firm Revisited' (1988) *Journal of Law, Economics and Organization* 4,141-162

³⁷⁹ S Bainbridge 'The Politics of Corporate Governance' (1995) 18 *Harv. J.L. & Pub Pol'y* 671, 674

³⁸⁰ Talbot (n 314)

³⁸¹ The recent financial crisis during the year 2007-2008 has been attributed to this irresponsible behaviour coupled with the ultra-relaxed regulatory regimes instituted in order to attract as many corporations as possible, leading to a race to the bottom. Stephen Bainbridge 'The Politics Of Corporate Governance' (1995), 18 *Harv. J.L. & Pub Pol'y* 671, 674

The second theme emanating from the separation thesis was the surge of socially responsible corporations,³⁸² manifested in the CSR movement and the stakeholder oriented corporate governance model.³⁸³ Although it was not explicitly stated by Berle and Means, most academics adopted the view that they were opposed to the company being run solely in the name of the shareholder because (according to them) this would give rise to managerial abuse of power. Accordingly, it is argued that this was a motivating factor in their reliance on corporations being run in a socially beneficial manner.³⁸⁴ One may have expected that the implementation of the socially responsible firm would be the logical extension of this debate, but it was not to come to fruition because of the political ascendancy of the finance model under the garb of neoliberal capitalism.³⁸⁵ According to Blair, to understand the divergent points of view there are three questions that must be answered: who and what is the corporation? What goals should it have? And whose interests should it serve?³⁸⁶

The majority of the literature in the corporate governance debate focuses on the last question, but it is imperative to our discussion of this question that the first two questions are explored first. To begin, we shall explore the theoretical basis of the constitution of a corporation.

4. Corporate theory: a brief introduction

The law has historically had difficulty providing an adequate definition of a company. Initially, it was deemed to be an extension of the property rights and

³⁸² T Donaldson & L E Preston 'The Stakeholder Theory Of The Corporation: Concepts, Evidence And Implications' (1995) *Academy Of Management Review*, 20: 65-91

³⁸³ M M Blair, *Whose Interests Should Corporations Serve?* in M.B.E. Clarkson (Ed.), *Ownership And Control: Rethinking Corporate Governance For The Twenty First Century*. Washington, Dc: Brooking Institution. Reproduced In *The Corporation And Its Stakeholders: Classic And Contemporary Reading*. Toronto: University Of Toronto Press. 1998)

³⁸⁴ Berle and Means (n 313)

³⁸⁵ Prof L E Mitchell, *The Speculation Economy: How Finance Triumphed Over Industry* (Berrette-Koehlere Publications. USA 2008)

³⁸⁶ M Blair, *Ownership And Control: Rethinking Corporate Governance For The 21st Century* (Brookings Institute Press. 1995)

freedoms of association and contract on the part of the property owner.³⁸⁷ Any one position of ‘what a company is’ can be defended by recourse to different theories that emphasise the importance of complex relationships that form the company.³⁸⁸ It can also be stated that the majority of theories that highlight one aspect or another of the corporation’s existence are direct reflections of the hegemony of the political system within which the corporation works and thus these theories have an immediate consequence for the corporate governance and regulatory debate surrounding the modern day corporate form.³⁸⁹ It is noteworthy that the same goes for IFIs, since most IFIs are incorporated with limited liability and dispersed shareholding in the jurisdictions within which they operate and come under the purview of the general corporate law regime of that jurisdiction, while simultaneously borrowing concepts from Islamic legal and economic theory. It is this mixed form that raises both practical and theoretical regulatory and governance conundrums for IFIs and thus raises the question of whether IFIs can be regulated by the same standards as other financial institutions. If not, a regulatory framework must be devised that allows for the implementation of universal Islamic ideals and principles, as well as maintaining jurisdictional regulatory standards.

Particularly problematic from a corporate governance and regulatory point of view is that a company is considered a legal fiction - a creation of law - whereas the people

³⁸⁷ Ibid Blair

³⁸⁸ H Demsetz, ‘The Theory Of The Firm Revisited.’ (1988) *Journal Of Law, Economics And Organization* 4,141-162 ; Cyert, R. And J. March ‘A Behavioural Theory Of The Firm.’ (Prentice Hall, New York 1963). For A Different Perspective Refer To: Evan, W., And Freeman, R. E, *A Stakeholder Theory Of The Modern Corporation: Kantian Capitalism* (1988) in T. Beauchamp & N. Bowie (Eds.), *Ethical Theory And Business*: 75-93. Englewood Cliffs, NJ: Prentice-Hall. And Also, R E Freeman ‘The Politics Of Stakeholder Theory: Some Future Directions. (1994) *Business Ethics Quarterly* 4(4): 409 – 421

³⁸⁹ Mark Roe, *Political Determinants Of Corporate Governance: Political Context, Corporate Impact* (OUP 2006)

running it are real.³⁹⁰ The fiction theory essentially says the legal person has no reality, mind or will of its own; it only exists because the law chooses to allow it to and is therefore ‘an artificial, intangible and invisible being’³⁹¹ and a mere creation of intellect.³⁹² Building on the fiction theory is the concession theory, which posits that despite its legally fictitious status, the state has allowed the corporation as a concession to the individual investors as a means to pool resources. It should be borne in mind that historically, the original joint stock companies (which were the predecessors of modern corporations) were given grants by the state to be set up incorporated. These grants were given because the companies were set up to serve the public interest.³⁹³ Thus, under the ‘concession theory’ the corporation owes its existence to a special concession from the state and therefore, by logical extension, the state has the right to regulate the corporation as a stakeholder.³⁹⁴ In essence, the concession theory – despite admitting it is a legal fiction - considers the corporation to be a separate entity from its owners. Accordingly, the corporation owes a duty to the state and not solely to the individuals who provide equity to the corporation.³⁹⁵

Another prominent theory is the real entity theory, which has its foundations in the nexus of contracts theory. The real entity theory considers the corporation as a real thing (‘a social fact with an actual living nature’)³⁹⁶ and not a merely juristic opinion. It further states that when individuals come together to form a corporation a new personality arises which has a ‘distinct sphere of existence and a will of its

³⁹⁰ R Coase ‘The Nature Of The Firm.’ (1937) *Economica* 4,386-405

³⁹¹ *Trustees of Dartmouth College V Woodward* (17 US) 4 *Wheat* 518 At 636, Per Marshall CJ. As Quoted In J.Lowry And A.Reisberg, *Pattet’s Company Law: Company Law And Corporate Finance* (4th Ed. Pearson Education Limited, England. 2012) 58

³⁹² *Ibid* J.Lowry and A Reiesberg 58

³⁹³ A Chandler, *The Visible Hand* Cambridge (Harvard University Press 1977)

³⁹⁴ C W Hill and T M Jones ‘Stakeholder-Agency Theory.’ (1992) *Journal Of Management Studies*, 29: 131-154

³⁹⁵ *Ibid* Blair 1995

³⁹⁶ Lowry and Reisberg (n 371) 58

own',³⁹⁷ the law merely recognises the association and does not necessarily create it.³⁹⁸ The nexus of contract theory, as a corollary of the realist theory, states that the corporation is nothing more than a manifestation of the pooled resources of, and contractual bonds between, private individuals as stakeholders.³⁹⁹ The argument is that the corporation is nothing more than a nexus of contracts between freely consenting entities and therefore is a wholly private enterprise.⁴⁰⁰ In sum, this nexus of contract theory states that a corporation is indeed a real factual entity and not a fiction and as a result has a legal personality of its own, being separate and distinct from the members running it.⁴⁰¹

The historical development of the law and the current form of the modern day corporation is a mixture of the concession and nexus of contracts theories. The existence of the right of individuals to form corporations is in support of the concession theory view.⁴⁰² There is also evidence of the nexus of contracts theory being utilised in modern day company law and corporate governance. An example is the definition of the article of association of a corporation as being a contract *inter se* as well as a contract between the company and the members.⁴⁰³

All of these theories have thus contributed to the current shape of both company law and the corporate governance debate. Understanding these theories is also very important from the regulatory point of view, since different theories support

³⁹⁷ F.Hallis *Corporate Personality: A Study In Jurisprudence* (OUP London 1930)

³⁹⁸ S Cheung 'The Contractual Nature of The Firm' (1983) *Journal of Law and Economics* 26, 403-411

³⁹⁹ Alciian and Demsetz (n 338) and Jensen and Meckling (n 349)

⁴⁰⁰ S Cheung (n 398)

⁴⁰¹ Jensen and Meckling (n 349)

⁴⁰² O Hart and J Moore 'Property Rights and The Nature Of The Firm.' (1990) *Journal Of Political Economy* 98(6), 1119-1158

⁴⁰³ Sec 33 CA 2006 and Also, S Cheung (n 398)

different forms of regulation.⁴⁰⁴ If one is to accept simply that the corporation is nothing but a nexus of contracts, then the resulting regulatory environment would be a ‘soft touch’ light regulation approach, whereby only the very basic issues are regulated by the state, the rest being left either to self-regulation by the industry or regulation through market forces.⁴⁰⁵ The shareholders would be the main stakeholders whose interests will need to be taken into account by the management, who would have no duty to take into consideration any other stakeholders. This is the model that is preferred by neoliberal thinkers and policy makers.⁴⁰⁶ On the other hand, if we accept the corporation is a concession given by the state to facilitate investment, then we can justify a more invasive regulatory regime. Since the corporation is conceptually no longer considered a private entity (having more of a ‘public body role’ under the concession theory), it therefore owes a duty to take into consideration the interests of other stakeholders like society in general, employees, customers, the environment etc.⁴⁰⁷ It is thus argued that a governance framework which is based on a neo liberal ideology of deregulation and profit maximization of the shareholders is ill suited for an industry like the Islamic finance industry, since profit maximization as the only goal fails to satisfy the ideological norms of Islamic finance and economics. Consequently, a regulatory framework which allows for the enforcement of the principles of Islamic finance as asserted by *sharia* is a more suited framework for IFIs.

⁴⁰⁴ K Pistor and C J. Milhaupt, *Law And Capitalism: What Corporate Governance Crisis Reveal About Legal Systems And Economic Development Around The World* (The University Of Chicago Press)

⁴⁰⁵ J Mccahery, Sol Picciotto and C Scott, *Corporate Control And Accountability Changing Structures And Dynamics Of Regulation* (Clarendon Press, Oxford 1993)

⁴⁰⁶ R Gilson ‘Corporate Governance and Economic Efficiency: When Do Institutions Matter?’ (1996) 74 Wash. U.L.Q. 327, 331

⁴⁰⁷ J Kay ‘*The Stakeholder Corporation*,’ in G. Kelly, D. Kelly and A. Gamble, (Eds.), *Stakeholder Capitalism* (London: Macmillan 1997)

5. The influence of the neo liberal thinking on judicial understanding of the corporation

Since corporations were economic and social necessities of their time, the question of what a corporation/ company was and for whom it was run was not explored until the late nineteenth century. Even then, the conception of a company was in a transitional state in the sense that the company was legally recognised as being run for the profits of the shareholder. In the landmark case of *Dodge v Ford motor Co* in 1919 the court categorically held that the corporation was owned by the shareholders and consequently they could force directors to pay out the profits to them. The courts held that ‘a business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end’.⁴⁰⁸ This decision was lauded by the chancellor of the state of Delaware as embodying the ‘property conception of the corporation.’⁴⁰⁹ This property conception of the corporation is associated with the Chicago school of law and economics (which can further be attributed to the Neo liberal ethos), and states that a corporation is a ‘nexus of contracts’ through which the various participants arrange to transact with each other.⁴¹⁰ In essence, the shareholders are seen as residual claimants to the assets of the company, and the managers are deemed to be obliged towards shareholders, as mere agents. Hence, it is argued under the Anglo US corporate governance theory that the managers ought not to be concerned with pursuing the interests of other stakeholders. Allen remarks that under this view of the corporation ‘the rights of the creditors, employees and others are strictly limited

⁴⁰⁸ *Dodge V. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919)

⁴⁰⁹ W T Allen ‘Our Schizophrenic Conception Of The Business Corporation’ 1992, *Cardozo Law Review* 14(2); 261-268

⁴¹⁰ Jensen and Meckling (n 349)

to statutory, contractual and common law rights.’⁴¹¹ This would mean that the rights of other stakeholders are external rights and are not to be taken as inherently a part of the corporation itself. This is a point of view which cannot be reconciled with the Islamic stance regarding property and the societal aspect of the forms of business and thus makes it ideologically incompatible with the Anglo US corporate governance theory.

The debate prompted by Berle and Means’ view of the corporation and the relationship between the shareholder and managers (over whether the corporation is a ‘social entity’) has become a much wider debate, between the proponents of shareholder value maximization and those of the shareholder theory.⁴¹² Berle and Means wrote in 1932 that ‘the American corporation had ceased to be a private business device and had become an institution’.⁴¹³ Votaw also alluded to the same understanding of the corporation, describing the modern corporation as a ‘constellation of interests rather than the instrument of the acquisitive individual.’ This shows how the perception of the role of the management has changed from managers being aggressive, profit and power seeking individualists to now being more diplomatic and statesman-like professionals. This view of the corporation is called the ‘social entity conception’, which states that the purpose of the corporation is ‘not individual but social’.⁴¹⁴ Allen went on to describe that in the 1960s and 1970s the corporation’s role was that of an institution where the interests of the shareholders, the main equity contributors and that of other constituents (the other stakeholders) have to be balanced. He also went on to assert the view that ‘no single

⁴¹¹ Allen (n 389)

⁴¹² Blair (n 363)

⁴¹³ Berle and Means (n 313)

⁴¹⁴ Votaw (n 338)

constituency's interest may significantly exclude others from fair consideration by the board.'⁴¹⁵

According to Blair,⁴¹⁶ it was only in the 1960s and the 70s that the corporation started becoming more socially responsive and responsible, and that may be one of the reasons that it hasn't been deemed necessary to impose legal sanction on such accounts of public benefit and public responsibility. This shows that in the 1960's and the 1970's, the idea of a corporation was still based on it being a social entity, but that soon changed with the ascendancy of the Neo Liberal mode of economics and law.

6. The Neo liberal ascendancy

The beginning of the 1980s saw a shift back towards the shareholder primacy version dominated by neoliberal political and economic thought. The main reasons for this shift were the rise of global competition, the internationalisation of financial markets and the emergence of hostile takeovers.⁴¹⁷ The increase in the takeover market shattered the adequacy of the long term conception for the company, which became irrelevant for outlining the corporate environment, which was a direct result of the rise of the neo liberal policies.⁴¹⁸ This economic shift was supplemented by a legal shift which saw the courts recognising that the only view that managers are obliged to consider is that of shareholder value maximization; as long as the value of the share is increasing, the managers are deemed to have performed their duties.⁴¹⁹

According to the American Law Institute the managers are only obliged to take into

⁴¹⁵ Allen (n 389)

⁴¹⁶ Blair (n 366)

⁴¹⁷ Blair (n 366)

⁴¹⁸ G Kelly and A Gamble (Eds.), *Stakeholder Capitalism* (Houndmills, Basingstoke: Macmillan 1997)

⁴¹⁹ T M Jones 'Instrumental Stakeholder Theory: A Synthesis Of Ethics And Economics.' (1995) *Academy Of Management Review* 20 (1), 404-437

consideration other stakeholders interests when ‘competing courses of action have comparable impact on shareholders’.⁴²⁰ This was reflected in the decision of *Paramount Communications Inc. v QVC Network Inc.*,⁴²¹ with the court iterating that the ‘directors had to act on an informed basis to secure the best value reasonably available to the stockholders’. This was so despite the earlier decision of *Paramount Communications v Time Inc.*,⁴²² which held that the company was to be run not solely for the benefit of the shareholders but the management should also take into account the interests of other stakeholders. This perfectly demonstrated the short term/long term distinction, with the court in the latter case preferring the view that the directors are to reject or accept the offer of a takeover looking primarily at the short term increase in the value of the shareholder,⁴²³ whereas in the earlier case the court did accept that the directors could take into account the long term strategic goals of the company as well as the interests of other stakeholders.⁴²⁴ Therefore, with divergent case law authorities on the issue, the law remains unclear and it is yet to be seen which way a court would rule if a stakeholder attempted to enforce their rights.⁴²⁵ This has also proven problematic in the UK, where section 172 of the Company Act 2006 actually lists other interests that the directors must take into account when coming to a decision regarding the company’s functions. There is also judicial authority that the directors owe a fiduciary duty to the company and must act in the interest of members as a whole.⁴²⁶

⁴²⁰ Clarke (n 351)

⁴²¹ *Paramount Communications Inc. V. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1993)

⁴²² *Paramount Communications Inc. V. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) F 94,514 (Del. Feb 1990)

⁴²³ *Paramount Communications Inc. V. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1993)

⁴²⁴ Clarke (n 351)

⁴²⁵ Blair (n 366)

⁴²⁶ *Percival Vs Wright* (1902) 2Ch 421, which laid down that directors owe a duty to the company as a whole but not to individual shareholders. Also put of statutory footing in sec 170 ca 2006

Even though the law may still be in limbo as to whether the stakeholder rights are actually enforceable, policy statements in the US (and to a certain extent in the UK, even though there is some movement for a change in the academia) are clear that the corporation is to be run primarily for the shareholder. One of the major reasons for such shareholder primacy is that it is widely accepted that the shareholders are likely to be the least protected of all stakeholders relative to their investment.⁴²⁷ This theory of shareholders having a residual claim has been reflected in the works of Bebchuk.⁴²⁸ One may justify this approach by viewing the shareholders as owners who are thus entitled to control the corporate resources and ensure that they are being used for their benefit.⁴²⁹ Furthermore, it may be said that the shareholders are the best people to hold the management accountable,⁴³⁰ along with the aforementioned argument that the shareholders are the residual claimants.⁴³¹ These points of view have formed the core of the shareholder theory and are followed religiously by adherents of the shareholder primacy theory in both academia as well as policy. This shareholder value maximisation point of view is manifested in the shape of ‘agency theory’ as well as the separation thesis.

7. Agency theory and the separation of ownership and control.

The underlying agency theory argument emanates from the economic theory of the firm as expounded by Berle and Means.⁴³² The classic economic theory perceived the firm as an entity with a single minded commitment to the maximization of

⁴²⁷ Blair (n 366)

⁴²⁸ L Bebchuk, ‘The Case For Increasing Shareholder Power’ (January 2005) Harvard Law Review, Vol 118, 833-917

⁴²⁹ Jensen and Meckling (n 349)

⁴³⁰ Jensen ‘Separation Of Ownership And Control’ (1983) Journal Of Law And Economics, Vol. 26, June. Available At SSRN: [Http://Ssrn.Com/Abstract=94034](http://Ssrn.Com/Abstract=94034) Or Doi:10.2139/Ssrn.94034

⁴³¹ Blair (n 366); Bebchuk (n 408)

⁴³² Berle and Means (n 313)

profits for the shareholders, with internal affairs of the firm also being regulated by market activity. As a result, market forces dictated how the firm should be run and under this particular theory it was solely to make profits.⁴³³

The agency theory explains the firm as a nexus of contracts among individual factors of production.⁴³⁴ The crux of the agency theory problem is how to separate management and finance because the managers in a firm help raise finances from investors (the shareholders) in order to put them to productive use and so are in control of that finance. The financiers (shareholders) on the other hand need the managers to manage their investments and generate returns on their funds.⁴³⁵ The nexus of contracts in this regard explains that the financiers and the managers sign a contract that specifies what the managers are to do with the funds and how returns are divided between them. The biggest issue in this relationship is that of residual control: who gets it?⁴³⁶ With whom should the right to make decisions vest? Should it be the shareholders since they are the ones who have provided the capital, or should it be with the managers who actually exercise control over the daily affairs of the company?⁴³⁷

Historically speaking, it is the managers who have retained the power to take decisions. The problem with this is that managers must be prevented from pursuing their own interests and from misallocating resources, whilst still allowing them to induce and encourage more investment.⁴³⁸ This is the classic corporate governance problem.⁴³⁹

⁴³³ Blair (n 366)

⁴³⁴ Jensen (n 410)

⁴³⁵ Clarke (n 351)

⁴³⁶ M Roe, *Strong Manager, Weak Owners: The Political Roots Of American Corporate Finance* (Princeton University Press 1994)

⁴³⁷ Jensen (n 410); Fama (n 341) Perrow (n 338)

⁴³⁸ Jensen and Meckling (n 349)

⁴³⁹ K M Eisenhardt 'Agency Theory: An Assessment And Review'. (1989), *Academy Of Management Review*, 14: 57-74

The agency theory looks to resolve this problem by proposing that shareholders have paramountcy in the firm because not only are they the owners, but also residual risk takers. According to Fama, under the nexus of contracts theory, the ownership of the firm is not of relevance.⁴⁴⁰ The agency theory contends that the shareholders are the principals in whose interest the corporation should be run because the shareholders are the residual claimants⁴⁴¹ and the only category of economic actors who make investment without any contractual guarantee of a specific return.⁴⁴²

Since the ideological basis of the agency theory is the self-interested utility maximising motivation of individual actors, it is assumed that the relationship between shareholders (principals) and managers (agents) will be problematic because the managers may be pursuing their own interests rather than those of the shareholders as is originally envisaged. The other important basis for the agency theory's eminence in the corporate governance debate is the trend of managerial hegemony. This means that the CEOs of the modern day company have become so powerful that they have rendered the board of directors impotent, undermining the shareholders and their ability to affect affairs.⁴⁴³ This unabated power of the CEOs allows the risk that they will base their governance on interests other than profit maximisation. Thus, the shareholders are no longer the ones in control of the firm and their interests are no longer considered primary. Rather, the CEOs decide how and where the profits of the company are reinvested, as well as how much

⁴⁴⁰ E F Fama 'Agency Problems and The Theory Of The Firm' (1980) *Journal Of Political Economy* Vol.88 P.288-307

⁴⁴¹ K Eisenhardt 'Control: Organisational and Economic Approaches' (1985). *Management Science*, 31, 134-49

⁴⁴² D E Colon and J Parks *The Effects Of Monitoring And Tradition On Compensation Arrangements: An Experiment On Principal/Agent* (1988)

⁴⁴³ J Kirkbride and S Letza, 'The CEO In Law And In Practice: A Study Of Categorization And Control' (2002) *Corporate Governance: An International Review*, Vol. 10, 136-152,. Available At SSRN: <http://ssrn.com/abstract=314286>

compensation they are to receive.⁴⁴⁴ This power of reinvestment that the CEOs have acquired means that they are no longer dependent solely on the shareholders for the provision of the capital for the running of the firm. This independence means that the shareholders are rendered not only powerless but also - to an extent - useless.⁴⁴⁵ So in reality, rather than the boards being in control of the management, it is the management who is in control of the board.

According to Jensen and Meckling, the conventional agency theory also states that since both the principals and the agents (the shareholders and the managers) are looking to maximise utility, there are inevitably going to be conflicts of interests and when faced with such a conflict, the agent may not always act in the best interest of the principal.⁴⁴⁶ One of the more important outcomes of the management not abiding by the conventional roles of agents is the rise in the 'agency cost'.⁴⁴⁷ In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (pecuniary as well as non-pecuniary) and these will be called the agency costs.⁴⁴⁸ These agency costs can be calculated as the sum of the monitoring expenditure by the principal, plus the bonding expenditures by the agent, plus residual costs. The monitoring expenditure can be defined as:

the cost that the principal will incur in order to ensure that the agent does not deviate from the aim of maximizing the value and the utility of the principal, the Bonding expenditure can be defined as the costs that the agents (management) will incur to guarantee that he will not take certain actions which would harm the principal

⁴⁴⁴ K Conner and C Prahalad 'A Resource-Based Theory Of The Firm: Knowledge Versus Opportunism.' (1996). *Organization Science* 7,477-501

⁴⁴⁵ L A Bebchuk, A Cohen and A Ferrell 'What Matters In Corporate Governance?' (September 1, 2004) *Review Of Financial Studies*, Vol. 22, No. 2, Pp. 783-827, February 2009; Harvard Law School John M. Olin Center Discussion Paper No. 491 (2004). Available At SSRN: <http://ssrn.com/abstract=593423> Or Doi:10.2139/ssrn.593423

⁴⁴⁶ Jensen and Meckling (n 349)

⁴⁴⁷ Jensen and Meckling (n 349)

⁴⁴⁸ M Roe, *Strong Manager, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press 1994)

(shareholder) or to ensure that the principal will be compensated if the agent does take such actions.⁴⁴⁹

It follows that the residual cost can be defined as the dollar (or equivalent currency) of the reduction in welfare experienced by the principal due to this divergence.⁴⁵⁰

Thus, it can be seen that the corporate governance issues relating to the agency relationship are not restricted to the question of whether they are ethical practices but are practically manifested in the actual pecuniary and non-pecuniary costs which directly and indirectly affect the overall performance and value of the company.⁴⁵¹

In line with the profit maximising aims and objectives of the corporation, Jensen and Meckling have categorically stated that in pursuit of profit, any expectation of a firm being socially responsible is an absurdity since:

‘the private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and the cash flows of the organization which can generally be sold without permission of the other contracting individuals.’⁴⁵²

Furthermore, Jensen and Meckling stated that the ‘firm is not an individual and the personalisation of the firm implied by asking questions such as what should be the aim of the firm or does the firm have a social responsibility is seriously misleading’.⁴⁵³ The firm is then the sum of a collection of complex relationships (i.e. contracts) between the legal fiction (the firm) and the owners of labour, material and capital inputs, and the consumer of outputs. Therefore, we must take into account the agency costs prevalent in the firm to decide how to structure the contractual

⁴⁴⁹ Jensen and Meckling (n 349) 11-12

⁴⁵⁰ Jensen and Meckling (n 349) 11

⁴⁵¹ Fama (n 420)

⁴⁵² Jensen and Meckling (n 349) 12

⁴⁵³ Jensen and Meckling (n 349) 12

relationships between the principal and the agent in a way that provides proper incentive for the agent to maximise the principal's welfare given that uncertainty and imperfect monitoring exists.⁴⁵⁴

This demonstrates that in the neoliberal theory of corporate governance there is no place for other stakeholders and the only aim of the corporation is to act as the facilitator between the principal's investments (the investors/shareholders) and the agent's (the management) capacity to manage that capital.

Building on this, one of the most important underlying questions concerning the corporate governance debate is the conundrum of how managers have the authority of making decisions in modern firms, but have no liability in the outcome and are not affected monetarily by such decisions.⁴⁵⁵ In other words, how are managers the main decision makers when they are not risk takers themselves? This means that the opposite is true for the shareholders: they are the risk takers but have no say in the decisions of the firm. It is this dichotomy of risk allocation and the decision making process that has been the focus of Fama and Jensen.⁴⁵⁶

Fama and Jensen have established a correlation between the residual claim and the decision-making process to justify giving the managers the authority and the legitimacy to make decisions without having to take any extraordinary risks.⁴⁵⁷ They claim that since an organisation is the nexus of contracts, it is these contracts that combine with the external legal requirement to determine and specify the rights of each agent in the organisation. It is by virtue of this central contract that the

⁴⁵⁴ Jensen and Meckling (n 349) 12

⁴⁵⁵ A Cosh and A Hughes 'The Anatomy Of Corporate Control: Directors, Shareholders And Executive Remuneration In Giant US And UK Corporations.' (1987) *Cambridge Journal of Economics* 11(4), 285-313

⁴⁵⁶ Fama and Jensen (n 341)

⁴⁵⁷ Fama and Jensen (n 341)

organisation specifies both the nature of the residual claims and the allocation in the steps of the decision process among agents.⁴⁵⁸

Therefore, the relationship that Fama and Jensen have established between the nature of residual claim and the allocation of decision-making is that the separation of residual risk bearing from decision management leads to decision systems that separate decision management from decision control. Furthermore, the combination of decision management and decision control in a small amount of agents leads to residual claims that are largely restricted to those agents.⁴⁵⁹

Eisenhardt, on the other hand, relies on the agency theory itself to justify the issue of 'risk sharing' that arises when the agent and the principal have different attitudes towards risk.⁴⁶⁰ The agency theory is regarded in terms of the different 'goals' and attitudes towards risk of both the agent (management) and the principal (shareholders). Eisenhart has used two streams of agency theory to justify how and when the principal and the agent may have different goals.⁴⁶¹ He first uses the positivist agency theory to focus on identifying the situation in which principal and agent are likely to have conflicting goals and then describes the governance mechanism that can be used to curb such behaviour of the agents. His first finding is that if the interest of both the principal and the agent are aligned by means of an outcome-based contract, the chances of a conflict of interest is less than (for example) increasing the firm ownership of the managers as it may decrease the chances of them working for self-interested goals.⁴⁶² Secondly he emphasises the importance of informational availability within the firm to ensure that the agents do not act in their own interests. This can only be achieved when the principal has the

⁴⁵⁸ Fama and Jensen (n 341)

⁴⁵⁹ Fama and Jensen (n 341)

⁴⁶⁰ Eisenhardt (n 419)

⁴⁶¹ Eisenhardt (n 419)

⁴⁶² Eisenhardt (n 419)

information to verify the agent's behaviour, providing the principal with the chance to actually reduce the cost of monitoring the agent, ensuring that the agent will be more careful about his actions.

He then focuses on the normative principal agent theory, asserting that information systems are positively related to behaviour-based contracts and negatively related to outcome-based contracts.⁴⁶³ Therefore, the information systems tend to work better in an environment where the contracts are based on the behavioural aspects of the agent rather than the outcome. This kind of a scenario may occur where, for example, the board of directors are not as well versed in the financial aspects of the company and the management takes certain decisions or work towards certain goals which the board of director may not understand. In such scenarios, it is better for the principal to be able to monitor the behaviour of the management rather than the goal that they may be alluding to.⁴⁶⁴

In summary, Eisenhart shows us that the agency theory may provide solutions to the issues surrounding the agency problem itself, insofar as it explains how the principal and agent can be made to cooperate on certain aspects of decision making. It also shows how the risks and the decision making process may be streamlined compatibly with the relationship of the managers and the shareholders and their so-called division of labour.⁴⁶⁵

8. Conclusion

In view of the neoliberal ascendancy, the regulatory debate surrounding the Islamic financial industry needs to be assessed in the light of the fact that the Islamic finance

⁴⁶³ Eisenhardt (n 419)

⁴⁶⁴ S Ghoshal and P Moran 'Bad For Practice: A Critique of the Transaction Cost 'Theory.' (1996) *The Academy of Management Review* 21, 13-47

⁴⁶⁵ Eisenhardt (n 419)

industry is unique in its nature; it embodies principles set out by the Qu'ran and *Hadith* of the Holy prophet Muhammad, and is normatively to be regulated by *sharia* (the Islamic law). With that in mind, and our earlier discussion of the agency cost argument focusing on the interest of the shareholders only, it can be seen why corporate governance and the regulatory framework needs to be specifically tailored to cater to the nature of the Islamic finance industry with a stakeholder and CSR orientation. Regulating the IFIs in any other way is likely to lead to serious systemic and reputational risks to the industry. Another important aspect in relation to IFIs is the issue of the added agency costs in the shape of the *sharia* supervisor boards (SSBs), and the question of how to credibly incorporate this issue into the modern day corporate governance debate. This is because the existence of SSBs upsets the conventional paradigm of the agency relationship between the shareholders and the managers, in that the SSBs form another layer of a mandatory advisory body in the IFIs, with their advice being integral to the running of the IFI as proper 'Islamic' institution. Another aspect that needs to be catered for is the concept of 'property' and the subsequent 'ownership rights' that are deemed to be integral to the conventional corporate governance framework, which are distinctly different in the context of the Islamic financial industry. In Islamic economics and finance literature all property belongs to the God almighty and man is seen as a mere trustee of that property, enjoying only limited ownership rights over any assets. Assets belong first to the collective social group (society, tribe, country etc.) and then to the individual, meaning that the concept of 'residual ownership' of the shareholders is alien to Islamic finance literature. This makes Islamic economics and finance 'stakeholder and socially oriented' rather than 'profit maximising' per se. Islamic teachings regard profit as positive thing, encouraging entrepreneurship and profit making, but

categorically stating that profit is seen as a means to a greater social end and not as an end in itself, which is the antithesis of the neoliberal profit maximising ideology. Since Islamic financial institutions (IFIs) generally operate in an increasingly international environment, the need for corporate governance and a specifically tailored regulatory framework which caters to the basic ideology of the Islamic economic model needs to be formed in a manner which may be applicable across the industry internationally and not restricted to Islamic countries. In order for that to happen, it is argued that a two-tiered principle based meta-regulatory framework which provides for the specific corporate governance and *sharia* compliance prerequisites of the Islamic financial industry needs to be instituted with the help of the major standard setting bodies i.e. the IFSB (Islamic Financial Services Board)⁴⁶⁶ and the AAOIFI (Accounting and Audit Organisation for Islamic Financial Institutions).⁴⁶⁷

It is also imperative that such a framework considers that many jurisdictions will not accept *sharia*. This makes it difficult for the IFIs to operate and enforce the rules and principles that are of importance to the industry, i.e. the legal and ethical principles of *sharia* regarding finance and commerce. In light of this systemic issue of the non-acceptability of *sharia*, a uniform regulatory framework needs to be instituted which is acceptable to both Islamic countries as well as other secular countries.

⁴⁶⁶ [Http://Www.Ifsb.Org/](http://www.Ifsb.Org/)

⁴⁶⁷ [Http://Www.Aaoifi.Com/](http://Www.Aaoifi.Com/)

CHAPTER 5 BUSINESS ETHICS, CSR AND STAKEHOLDER THEORY

1. Introduction

In this chapter, we will establish the similarities between Islamic finance theory, conventional business ethics and corporate social responsibility (CSR) theory in addition to exploring the alternative corporate governance stakeholder theory (which is discussed in the next chapter) as a possible practical manifestation of the Islamic business ethos that has its ideological underpinnings in business ethics and CSR literature. Thus, we will move towards establishing that the stakeholder theory is the correct approach to corporate governance in the Islamic finance industry.

2. Business ethics and CSR: the historical context

One of the most viable attacks on the neoliberal conception of the market and the corporation comes from the business ethics school of thought. This school of thought forms the philosophical background to the stakeholder theory and CSR, making a case for further development of the stakeholder theory and CSR on the basis of the argument that the stakeholder theory and CSR actually reflect the practical realities of normative ethical concepts. This relationship between business ethics, CSR and the stakeholder point of view has been described in the following terms:

a stakeholder approach grounded in ethical theories presents a perspective of corporate social responsibility in which ethics is central. This represents clear

progress in the understanding of the integration of ethics into strategic management. In fact, there is a connection between strategic thought and ethical reasoning.⁴⁶⁸

On the other hand, the business ethics philosophy also directly targets the conception of the agency theory, stating that one of its drawbacks is that it does not take issues of ethics into account when comprehending the overall corporate strategy at both the macro and micro levels.⁴⁶⁹ The agency theory concentrates solely on profit maximisation which renders ethical issues as peripheral and less important.⁴⁷⁰ Issues of ethics can be well-amalgamated into the corporate sector only through the stakeholder point of view, which encourages different stakeholders to be a part of the corporate strategy both at the macro- and the micro-level.⁴⁷¹

Historically, the movement for CSR can be traced back to the debate between Berle⁴⁷² and Dodd,⁴⁷³ who stated that at the heart of the corporate governance debate lies what has popularly become known as the 'agency problem' or the 'agency debate'. As seen in the last chapter this debate essentially asks whether management is obliged to take into account the interests of stakeholders other than the shareholders. One of the foremost proponents of the modern day Anglo US corporate governance theories Berle said that corporate powers are 'powers in trust for shareholders and nobody else'.⁴⁷⁴ In response, Dodd wrote that in essence:

⁴⁶⁸ D Melé and M Guillén 'The Intellectual Evolution of Strategic Management And Its Relationship With Ethics And Social Responsibility', Working Paper WP No 658 October 2006. Electronic Copy Of This Paper Is Available At: [Http://Ssrn.Com/Abstract=960663](http://Ssrn.Com/Abstract=960663)

⁴⁶⁹ R Aguilera, V Williams, A Conley and D Rupp 'Corporate Governance And Social Responsibility: A Comparative Analysis Of The UK And The US.' (2006) *Corporate Governance: An International Review* 14 (3), 147-158

⁴⁷⁰ S L Berman, A C Wicks, S Kotha and M T Jones 'Does Stakeholder Orientation Matter? The Relationship between Stakeholder Management Model and Firm Financial Performance.' (1999) *Academy Of Management Journal*. 42 (5), 488-506

⁴⁷¹ M L Barnett 'Stakeholder Influence Capacity and the Variability of Financial Returns to Corporate Social Responsibility.' (2007) *Academy Of Management Review*, 32(3): 794-816

⁴⁷² A A Berle 'Corporate Powers as Powers In Trust' (1931) *Harvard Law Review* 44:1049

⁴⁷³ M Dodd 'For Whom Corporate Managers Are Trustees (1932) *Harvard Law Review* 45:1145

⁴⁷⁴ Berle (n 472)

‘The business can be classified as private property only in a qualified sense and that the society and its other stakeholders may demand that the business be carried out in such a way which promotes other stakeholder interests even if that would mean that the proprietary rights of the owners are curtailed.’⁴⁷⁵

Hence, Dodd laid down what some claim is the ideological foundation of modern day CSR and the stakeholder theory. In response to this, Berle further elaborated and said that making the managers responsible to multiple parties would render them less answerable than if they were made solely responsible to the shareholders.⁴⁷⁶ This seminal debate thus forms the crux of the basic corporate governance debate about managers’ responsibility towards shareholders and other stakeholders. The basic question can then be formulated in the following terms: are the managers responsible only to the shareholders or are they obliged to take into account other stakeholders’ interests too? Furthermore, if they are to be made responsible to other stakeholders, what mechanisms can facilitate this? These questions have been answered by CSR and stakeholder proponents in detail through the growing number of academic works and practical codes⁴⁷⁷ being produced by both the legal and the business communities.⁴⁷⁸

⁴⁷⁵ Dodd (n 473)

⁴⁷⁶ A A Berle ‘For Whom Corporate Managers Are Trustees: A Note’ (1935) Harvard Law Review 45:1365

⁴⁷⁷ American Law Institute’s Code on Corporate Governance: http://www.ali.org/index.cfm?fuseaction=Publications.Ppage&Node_Id=88.

⁴⁷⁸ Examples include codes of conduct by the ILO-bureau of worker’s activities, Codes of Conduct for Multinationals (<http://www.ilo.org/english/actrav/telearn/global/ilo/guides/main.htm#concept>) and the UN global compact (<http://www.unglobalcompact.org/un/gc/unweb/nfs.htm>) other examples of companies taking their own initiatives include the initiative taken by Livistrauss & co Global sourcing & operational guidelines (<http://www.ilo.org/english/actrav/telearn/global/ilo/code/levi.htm>) the apparel industry and codes of conduct : a solution to the child labor problem? (<http://www.dol.gov/dol/ilab/public/media/reports/iclp/apparel/main.htm>) and Reebok’s Human Rights Production Standards. (http://www.reebok.com/reebok/us/human_rights/standards.htm)

However, it is Freeman who in his book *Strategic Management*⁴⁷⁹ gave the concept of stakeholder management a formal recognition as a practical form of corporate governance system. The stakeholder concept basically seeks to answer the argument of in whose favour should the corporation be run and sets out what constitutes a 'stakeholder' in context of a company. According to Freeman, the stakeholders are 'those groups which make a difference'⁴⁸⁰ or more formally: '[a] stakeholder in an organization is any group or individual who can effect or is affected by the achievement of the organization's objectives.'⁴⁸¹ The term 'stakeholder' in the context of a company/ firm encompasses a wide range of stakeholders that may not be usually understood as being of significance under the Anglo US corporate governance theory.⁴⁸² Thus a good definition of a stakeholder that encompasses the ideological theme of the stakeholder theory is 'any group or individual that can be influenced by or can itself influence the activities of the organization'.⁴⁸³

Friedman and Miles have argued that the most common way of classifying stakeholders is to 'consider groups of people with a distinguishable relationship with corporations: shareholders, customers, suppliers and distributors, employees and local communities'.⁴⁸⁴ Some writers, like Dill, take an alternative approach and look at the stakeholders as an integral part of the business rather than as outside players, thus giving them a legitimate say in the company's affairs.⁴⁸⁵

Freeman believes that the pertinent question is 'how can executives in corporations begin to understand and manage in the external environment which they currently

⁴⁷⁹ R E Freeman, *Strategic Management: A Stakeholder Approach*. (Boston, Ma: Pitman 1984)

⁴⁸⁰ Ibid Freeman

⁴⁸¹ Ibid Freeman

⁴⁸² Ibid Freeman

⁴⁸³ R H Gray, D L Owen, and Adams, *Accounting And Accountability: Changes And Challenges In Corporate Social And Environmental Reporting* (Hemel Hempstead, UK Prentice-Hall 1996)

⁴⁸⁴ A L Friedman, S Miles, *Stakeholders: Theory and Practice: Theory and Practice* (OUP 2006)

⁴⁸⁵ W Dill 'Public Participation In Corporate Planning: Strategic Management In A Kibitzer's World' (1975) *Long Range Planning* 8(1): 57-63

face?’⁴⁸⁶ Simply put, how can organisations configure themselves and take actions to align themselves with the external environment, regulatory or otherwise?

Corporate social responsibility, like the stakeholder point of view, argues that the corporation does not exist solely to provide returns to the shareholder. Rather, they must serve a larger social purpose which would mean that the corporation should be managed in a socially responsible way.⁴⁸⁷ This view is the one that has given rise to the issues surrounding the CSR debate which basically says that the corporation exists to create wealth for the society and not solely for the shareholder. In addition, the role of the directors and managers is to see that the firm maximises wealth creation only after they have considered the social responsibility of the corporation as opposed to the shareholder primacy or agency point of view.⁴⁸⁸

Votaw also alluded to the same understanding of the corporation, describing the modern corporation as a ‘constellation of interests rather than the instrument of the acquisitive individual’. This view of the corporation is called the ‘social entity conception’ stating that the purpose of the corporation is seen as ‘not individual but social’.⁴⁸⁹

Another aspect of the CSR conception is the relationship between the corporation and the government. According to Freeman, this interaction outlines the environment that the modern day corporation has to function in.⁴⁹⁰ This inclusion of the government as a stakeholder is fundamentally important for the basis of the regulatory debate in modern day corporate governance literature.

⁴⁸⁶ Freeman (n 459) 43

⁴⁸⁷ Blair (n 366)

⁴⁸⁸ N E Bowie and R E Freeman (Eds) *Ethics And Agency Theory: An Introduction* (New York: Oxford University Press 1992)

⁴⁸⁹ V Dow, *Modern corporations* (Prentice-Hall 1965)

⁴⁹⁰ Freeman (n 459) 40

The literature on CSR has widely influenced the stakeholder debate as enunciated by Johnson, according to whom ‘social responsibility in reference to firms concerns the balancing of a multiplicity of stakeholder interests’,⁴⁹¹ and Davis, who said that ‘social responsibility begins where law ends’⁴⁹² which in essence meant that social responsibility is something that is above and beyond the normal legal relationship in the company that included taking into consideration other stakeholders.

On the other hand, the business ethics school of thought relies on another very important concept; that of the ‘common good’. This is as much a part of business ethics as it is an economic theory. It is thus argued that this concept of common good has a resonance with the basic concepts of the business ethos and the fundamentals of the economic framework of Islamic finance. The concept of common good can also be extended to formulate the basis of another concept; that of ‘public good’ as is used in the context of financial regulation literature and therefore the idea of a ‘common good’ can also be analogised with the ideals of *Maslaha* (public benefit) as enunciated in Islamic jurisprudence. The use of the ideals of *Maslaha* as an analogous concept with ‘Common good’ ideals will form a very strong basis for using the stakeholder theory as the main governing theory for modern day Islamic financial industry both in operational terms as well as regulatory terms.

This idea of common good has been borrowed from the political domain, and an analogy can be drawn between how the same principle of working towards a common good applies to the corporation as much as it applies to the state and the

⁴⁹¹ H L Johnson, *Business In Contemporary Society: Framework And Issues* (Belmont, Ca: Wadsworth 1971)

⁴⁹² K Davis ‘The Case For And Against Business Assumption Of Social Responsibilities’ (1973) *Academy Of Management Journal*, 16/2, 313

government.⁴⁹³ The fundamentals of the 'common good' concept emanate from the writing of Thomas Aquinas,⁴⁹⁴ who introduced the concept of common good as being something that binds a sovereign leader and constrains him/her from acting only in his own interest. Aquinas states that his office or duty is to further the common good such that the government does not exist to further the self-interests of those governing. This concept when transposed to the modern day corporation then reads as meaning that the purpose of the corporation is not to merely further the goals of the owners or managers, but rather it has to work to further the goal of a common good that extends to benefit a wider array of stakeholders.⁴⁹⁵ The idea of the common good also furthers the idea of office in the political arena and the moral nature of the idea of power. The idea of the office - and hence power - is thus bounded by the fact that both power and office are to be used to further the common good for society as a whole.

One of the aims of the 'common good' is the furtherance of the concept of distributive justice, which is a central theme that can be found in Islamic finance literature.⁴⁹⁶ Distributive justice can simply be defined as 'concerning the fair, just or

⁴⁹³ A Argandona 'The Stakeholder Theory And The Common Good', (1998) *Journal Of Business Ethics*, 17: 1093-102

⁴⁹⁴ St. Thomas Aquinas, a medieval Roman Catholic scholar, reconciled the political philosophy of Aristotle with Christian faith. In doing so, he contended that a just ruler or government must work for the "common good" of all. In 1267, Thomas Aquinas completed a work on government inspired by Aristotle's politics. Aquinas asserted, "yet it is natural for man, more than any other animal, to be a social and political animal, to live in a group." he presented logical proofs of this such as the self-evident fact of human speech to allow individuals to reason with one another. Aquinas further observed that people tend to look only after their own self-interest. "therefore," he concluded, "in every multitude there must be some governing power" to direct people toward the "common good." even though a Christian concept, the idea of 'common good' can easily be reconciled with the teachings of Islam and is thus very pertinent to the Islamic way of governance, of both the state and the economy(business).

⁴⁹⁵ Grayson, David and Adrian Hodges, *Everybody's Business: Making Risks and Opportunities in Today's Global Society* (London: Dorling Kindersley Ltd 2001). And Elaine Stenberg, *Just Business: Business Ethics in Action* (. London: Little, Brown And Co 1994) P W F Davies, *Current Issues In Business Ethics*(Routledge, London 1997)

⁴⁹⁶ F Pomeranz 'Business Ethics: The Perspective of Islam' (1995) *The American Journal Of Islamic Social Sciences*. 12 (3), 400-404

equitable distribution of benefits and burdens'.⁴⁹⁷ In economic terms, the resultant wealth and benefits accruing from any financial activity should be distributed amongst society such that justice is done to all segments of it. To reiterate, this concept of distributive justice forms the back bone of economic and social fabric of society from an Islamic point of view.⁴⁹⁸ It can be argued that distributive justice from an economic perspective forms the main normative concept of any financial system, since it lays down what a financial system should strive to achieve. It can also be argued that for a financial system such as Islamic finance, the regulation of financial activity has to be carried out in line with the aim of furthering the common good or *Maslaha* (public good), as a well regulated economic system would go a long way in furthering the basic aims and objectives (the *Maqasid al Sharia*) of Islamic economic principles.⁴⁹⁹

It must also be mentioned here that although there is no generic corporate governance theory of Islamic finance, these three concepts of stakeholder theory, CSR and business ethics have ideas that overlap with the business ethos and fundamentals of Islamic finance. For this reason and for the purpose of this thesis, the concepts of stakeholder, CSR and business ethics will be used interchangeably. However, as a corporate governance theory, the stakeholder theory will be asserted as the singular theory which is appropriate for the Islamic finance industry as a whole both managerially as well as in a regulatory context.

⁴⁹⁷ M A M Haneef 'Islam, The Islamic Worldview, And Islamic Economics' (1997) HUM Journal Of Economics And Management. 5 (1), 39-65

⁴⁹⁸ S H Azmi 'Traditional Islamic Social Welfare: Its Meaning, History And Contemporary Relevance.' (1991). Part I-III. Islamic Quarterly. XXXV And XXXVI (3,4 And 1)

⁴⁹⁹ Haneef (n 477)

3. An ethical and ‘socially responsible’ corporation critique of the neoliberal model and the suitability of the stakeholder theory for contemporary IFIs

The origin of the word ethics can be traced as far back as Plato and Aristotle, when the Greek philosophers used to use the word *ethika* to describe their own studies of Greek values and ideals.⁵⁰⁰ It follows that business ethics form a part of a wider philosophical debate surrounding ethics, economics and law, the crux of which is the following question: why have ethics in business in the first place? This debate is represented by the ideological differences between the proponents of the stakeholder-oriented corporate governance idealists versus the shareholder primacy proponents in the conventional corporate governance literature.⁵⁰¹ It has greater significance for the Islamic finance industry for reasons that we have already explored; namely that Islamic finance is built on the basis of a moral and ethical system of economics and financial intermediation.⁵⁰²

Business ethics have two aims according to Zimmerli and Assländer, the first being that they ‘attempt to expand the concept of economic rationality by means of ethical consideration concerning economic action’ and the second being that ‘by outlining the basis of economic theories and questioning their relevance, they also act prescriptively by formulating and justifying ethical criteria which economic action must meet’.⁵⁰³

Western academics, like Islamic philosophers and jurists, have argued that ethics provide the basic rules of an ethos, but that those rules are not limited to that ethos.

⁵⁰⁰ R C Solomon, *Introduction To Ethics* in Walther Ch. Zimmerli And Klaus Richter Markus Holzinger (Editors) *Corporate Ethics And Corporate Governance* (Springer-Verlag Berlin Heidelberg 2007)

⁵⁰¹ Ibid Zimmerli 19

⁵⁰² Ch 3 of This Thesis

⁵⁰³ W C Zimmerli and M S Assländer, *Business Ethics As Applied Ethics*, in Walther Ch. Zimmerli · Klaus Richter And Markus Holzinger (Ed) *Corporate Ethics And Corporate Governance* (Springer-Verlag Berlin Heidelberg 2007)

This makes ethics a much wider concept than morality itself, since ethics not only reflects the ethos of a particular community, but rather transcends national and cultural boundaries, reflecting more universal concepts by devising what is universally right and wrong.⁵⁰⁴ This assertion then brings us to a central dilemma of contemporary business ethicists in the form of the ‘rational choice theory’, which presumes that an economically rational man will always act for his economic self-interest and that is the motivation behind all his actions.⁵⁰⁵ This idea of an economically rational man has been a central theme in the debate between those who follow business ethics, reflected in the ideology and practices of CSR and stakeholder theory and those who follow the neoliberal ethos. This debate has been perpetual since the time of Adam Smith,⁵⁰⁶ who believed that economic rationality (economic self-interest) was the motivation behind all economic activity.

4. The failure of the economically rational man and the shattered illusion of Neoliberal logic

The debate surrounding the selfish (or otherwise) motivation of man is, however, much older than Adam Smith. Indeed, contemporary economists who follow the rational choice theory trace this idea as far back as Plato.⁵⁰⁷ The ancient philosophers, just like the Islamic philosophers and jurists, were actually concerned with deeper philosophical questions than merely trying to solve the economic choice conundrum of man. However, to answer this question in this thesis requires the asking of two other questions: why would corporations or their owners ever act in

⁵⁰⁴ Salmon (n 480) 17-18

⁵⁰⁵ P Wicksteed, *The Common Sense Of Political Economy* (George Rutledge And Sons, London 1933) ; L.Robins, *An Essay On The Nature And Significance Of Economic Science* (3rd Edition, Macmillan, London 1984)

⁵⁰⁶ Adam Smith, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations* (Mod .Lib. Ed 1937)

⁵⁰⁷ Salmon (n 480)

the interest of anyone but themselves? And why should a corporation be more socially responsible if their sole duty is towards their stockholders?⁵⁰⁸ The answer to these can only be logically deduced once it is proven that following CSR or the stakeholder theory leads to some kind of financial or other equally important incentive, since according to the rational choice theory the pursuit of profit is the sole motive to act for any rational person (including a corporation).⁵⁰⁹ The economic rational choice theory also fails to prove why the corporation would ever act benevolently. These questions raise serious doubts about the underlying suppositions of the rational choice theory as well as the neoliberal theory, as the rational choice theory is the predecessor of the neoliberal economic ideals in both politics and economics.⁵¹⁰

The answer can be divided into two strands. The first strand accepts the supposition that the only motivation for a rational person is economic, then goes on to prove that to follow CSR and the stakeholder theory makes economic sense, which culminates in the long-term versus short-term profit debate,⁵¹¹ a discussion we have had in the previous chapter while discussing the origins of the modern corporate form.

The second line of argument begins by rejecting the supposition that there is such a thing as an economically rational man (person or body) who is in possession of the relevant information about the market. This argument has been put forward by the likes of Donald Wood,⁵¹² Mitnick⁵¹³ and Arrow⁵¹⁴ in their criticisms of the

⁵⁰⁸ A B Carroll 'The Pyramid Of Corporate Social Responsibility: Toward The Moral Management Of Organizational Stakeholders' (1991) *Business Horizons*, 34(4): 39-48

⁵⁰⁹ Berman, Wicks, Kotha, and Jones (n 450)

⁵¹⁰ M B E Clarkson 'A Stakeholder Framework for Analyzing And Evaluating Corporate Social Performance.' (1995). *Academy Of Management Review* 20: 92 -117

⁵¹¹ J Collier 'Theorizing The Ethical Organization' (1998) *Business Ethics Quarterly*, 8(4): 621-654.

⁵¹² D J Wood, *Corporate Responsibility and Stakeholder Theory: Challenging The Neo Classical Paradigm* 2008

⁵¹³ B M Mitnick, *The Political Economy Of Regulation: Creating, Designing, And Removing Regulatory Forms*. (New York: Columbia University Press 1980)

neoliberal school of economics. On similar lines as academics in Islamic finance,⁵¹⁵ these criticisms put forward by western academics point to the inevitability of ethics creeping in as value judgements of senior managers as an indispensable part of making business decisions since the perfect conditions that the neoliberal school of economics presume for a rational economic judgement are neither available nor possible.⁵¹⁶ The role of value judgements of the management in the corporation have to be taken in context of the fact that many managers may not pursue pure economic goals such as profit maximisation at the cost of other ethical goals like the welfare of its employees.⁵¹⁷ Thus, the assumption by the neoliberal school that economically rational persons never act benevolently is being proven wrong in the current economic climate where many CEOs and managers are pursuing goals that may go against the pure economic interests of their own company.⁵¹⁸ Examples of this include the pursuit of environmental goals on a voluntary basis, even at the risk of incurring higher operational costs than their competitors, and pursuing ethically sound business practices like positive discrimination towards female employees or those with a more diverse racial background.⁵¹⁹ These practices seem to be clear instances in which the rational choice theory fails to establish itself as the sole theory explaining the behaviour of rational persons. This is even more pronounced in the Islamic finance literature, where it is not only inevitable that such considerations

⁵¹⁴ K L Arrow, *Individual Choice Under Certainty And Uncertainty* (Cambridge, Ma: Belknap Press 1984)

⁵¹⁵ Z Iqbal and A Mirakhor, 'Stakeholders Model Of Governance In Islamic Economic System.' (2004) *Islamic Economics Studies*. 11 (2), 43-63

⁵¹⁶ R Davies, *The Business Community: Social Responsibility And Corporate Values* In J. H. Dunning, *Making Globalization Good: The Moral Challenge Of Global Capitalism* (Oxford University Press, Oxford 2003)

⁵¹⁷ K Gibson 'The Moral Basis of Stakeholder Theory' (2000). *Journal Of Business Ethics*. 26, 245-257

⁵¹⁸ M C Jensen 'Value Maximization, Stakeholder Theory, and The Corporate Objective Function.' (2000), *Business Ethics Quarterly* 12(2)2: 35-256

⁵¹⁹ M T Jones, W Felps, and G A Bigley, 'Ethical Theory and Stakeholder-Related Decisions: The Role of Stakeholder Culture.' (2007). *Academy Of Management Review*, 32(1)1: 37-155

will creep into managements decisions; such considerations are regarded as important factors in the decision-making process, since to neglect this would be incompatible with the fundamentals of Islamic finance literature and become both practically and conceptually redundant.⁵²⁰

Secondly, the neoliberal school of thought has wrongly presupposed that rationality is based on information that is perfectly and uniformly available throughout the market.⁵²¹ The economically rational man's eventual decision to pursue any course of action will tend to be misguided as he will never be in possession of information as to what the other economically rational players will do in the market. Furthermore, the quantity and quality of information available in the market makes it nearly impossible for any economically rational person or body to digest it in its entirety. This informational asymmetry in the free market economy is a significant hurdle for the neoliberal claim that economic rationality is the best and the sole motivation for any person to act.⁵²² It is thus argued that it is not only ethical but also legally and pragmatically necessary that information is made available as a matter of right to the whole of society so that accountability as well transparency is ensured by all the stakeholders. This can only be done once corporate governance is geared to be more stakeholder-oriented and not only limited to shareholder interests.⁵²³

Zimmerli and Assländer have pointed out this barrier, stating that

this discrepancy between "economic reality" and the reality which the individual faces in the actual situation where the decision is made implies that if we take the

⁵²⁰ K Ahmad *Islamic Ethics In A Changing Environment For Managers* in A. M. Sadeq *Ethics In Business And Management: Islamic And Mainstream Approaches* (Asean Academic Press, London 2002)

⁵²¹ A Bryman 'Organizational Studies and The Concept Of Rationality' (1984). *Journal Of Management Studies* 21 (1), 391-408

⁵²² J Korhonen 'The Dominant Economics Paradigm And Corporate Social Responsibility' (2002) *Corporate Social Responsibility Environment Management* (9), 67-80

⁵²³ R Agle, B Wood, D Mitchell 'Towards A Theory Of Stakeholder Identification: Defining The Principle Of Who And What Really Counts.' (1997) *Academy Of Management Review* 22(4), 853-86

concept of economic rationality as a measure for decisions, then it is in fact impossible to be fully informed. The concept of economic rationality unrealistically assumes that the individual is fully informed. However, full knowledge cannot be acquired, due to the individual's limited capacity to absorb information and the transaction costs of procuring it.⁵²⁴

Popper adds that 'economists who base their theories on market success are facing the problem that it is impossible to be fully informed of future events. Thus, action always takes place in conditions of partial ignorance and uncertainty'.⁵²⁵

From the above two arguments, we can see that even if all other variables in economic decisions remain constant, the fact that it is impossible to predict what the other market players will do will make the 'rational' economic decision ironically very irrational. Building upon this, such 'partial ignorance and uncertainty'⁵²⁶ makes it difficult to justify the economic rationality of the market decisions which are void of any ethical influence, since these decisions will not lead to the best possible results as propagated by neoliberal economists. This lack of knowledge on the part of individual players, combined with the fact that rational choice theory fails to take into account benevolent acts that are not profit-driven, makes a compelling case for decisions being made in accordance with ethical principles rather than second guessing the practices of other players in the market.⁵²⁷

Donald Wood,⁵²⁸ when quoting Akerlof, points out some of the false assumptions underlying the neoclassical economic theory. The major false assumption that he brings attention to is the tendency of people to act irrationally (i.e. contrary to their

⁵²⁴ Zimmerli and Assländer (n 483)

⁵²⁵ K R Popper, *The Poverty Of Historicism* (2nd Ed. London 1960)

⁵²⁶ Zimmerli and Assländer (n 483) 39-40

⁵²⁷ H Simon 'Theories of Decision Making In Economics.' (1959) *American Economic Review* 49,56-65

⁵²⁸ Wood (n 492)

economic interests). This means that the neoclassical theory relies on the false pretext that people will not serve their own interest and instead let things be handled by the markets, which would be desirable because people in power would not exploit the markets. This clearly does not represent the realistic position where people do frequently exploit their positions for reasons of self-interest. This is one of the reasons why Islamic business ethics do not revolve around the economic rationality of man and attributes all financial and economic decisions and actions as being in the domain of the collective as embodied in the set principles and *sharia*.⁵²⁹

Another example of this false assumption can be seen in the works of Jensen, who says that ‘in the absence of externalities and monopoly, social welfare is maximized when each firm in an economy maximizes its total market value’.⁵³⁰ This leads readers to believe that in a perfect competition, firms will pursue only the interest of increasing their values and no one would be pursuing any economic self-interest. One of the biggest flaws of this statement by Jensen and other writers who propagate the shareholder theory is the oversight of the behavioural flaw of human and organisational irrationality. This distorts the underlying assumption of the shareholder theory of the managers’ benevolent intentions when given unabated power in a corporation.⁵³¹

This neoliberal conception of a perfect market is something that cannot be reconciled with her ethos of an Islamic economic system. Despite the recognition by Islamic finance literature of some aspect of private property and the freedom to

⁵²⁹ T J Al-'Alwani and W A El-Ansary, *Linking Ethics And Economics: The Role Of Ijtihad In The Regulation And Correction Of Capital Markets* (Centre For Muslim-Christian Understanding: History And International Affairs, Georgetown University. Virginia 1999)

⁵³⁰ Michael Jensen ‘Value Maximization, Stakeholder Theory and The Corporate Objective Function’ (2002) *Business Ethics Quarterly*, 12(2), 235-47

⁵³¹ B Staw ‘Rationality and Justification In Organizational Life.’ (1980) *Research In Organizational Behavior* 2,45-80

pursue economic interests,⁵³² there is no place for the assumption that markets are the best resources allocators for the society,⁵³³ and therefore Islamic rules have laid down certain basic parameters which are essential at both the macro- and micro-levels. Some of these parameters are the ban on *riba* and *gharrar*, which in simple terms means a ban on interest and speculation (or future trading). This alone is sufficient to negate any similarities between the Islamic finance theory and modern financial theories since modern economic systems are built on the concepts of lending on interest and speculating, which are two aspects which allow the modern day banking/financial industry to thrive and thus create debt.⁵³⁴ The other major aspect of Islamic financial thought that is not compatible with modern conventional financial practice is the concept of having any economic activity that is divorced from real asset, which forms the basis of Islamic financial intermediation, and is not something which is taken into account in conventional financial systems which work on creating wealth from debt.⁵³⁵ In Islamic financial literature, such a practice is not allowed and is against the precepts of *sharia* and therefore illegal.

Another reason why the shareholder theory fails is that the problems associated with agency, incentive, control,⁵³⁶ asymmetrical information and distorted knowledge⁵³⁷ are so well entrenched into neoliberal economics that there is very little room to improve at the corporate level without improvement at the macro-level. Stone is of the view that since it is not possible to control all externalities surrounding the

⁵³² M A Afzalur-Rahman, *Economic Doctrines Of Islam* (Islamic Publication, Lahore 1974)

⁵³³ S A Rosly, *Critical Issues On Islamic Banking And Financial Markets* (Author house 2005)

⁵³⁴ M T Usmani, *An Introduction To Islamic Finance* (Karachi, Pakistan, Idaratul Ma'aririf 2000)

⁵³⁵ Vogel And Hayes (n 17)

⁵³⁶ Mitnick (n 493)

⁵³⁷ Arrow (n 494)

corporation, the underlying assumption of the shareholder point of view cannot be accepted at face value.⁵³⁸

In the national meeting of the Academy of Management in 2007, an ‘all academy’ symposium on the future of stakeholder theorising in business was held; writers from across the USA gathered and delivered their short papers on the ongoing stakeholder debate and the criticisms of the conventional shareholder theory.⁵³⁹

Presented at this symposium, Donald J Wood’s paper quoted George Akerlof, the president of the American Economic Association, as criticizing in very open terms the current economic and the social structure.⁵⁴⁰ Phillips’ works added that the current ability of the government to intervene has been curtailed to such an extent that the government is completely powerless to do anything about corporate abuses and market manipulation, and that this can be attributed to the fact that neoclassical ideology was allowed to take precedence over the other political ideologies in the economic sphere.⁵⁴¹ It was this prevalent neoclassical political and economic approach that led to the downfall of the economic system, specifically the failure and the spate of scandals in the financial and the corporate sector. According to Sen⁵⁴² and Wood et al:⁵⁴³ ‘whereas globalization has brought many good things, it has also led to the dominance of the MNC, a form of corporation which has no master, and has contributed greatly to the income inequities, dire poverty, human rights abuse, environmental degradation and so much more’. Ehrenreich asserted that ‘the free market economy works best for the extremely rich and powerful but not for anyone

⁵³⁸ A Stone ‘A Regulation And Its Alternatives’(Washington, Dc: Congressional Quarterly Press 1982)

⁵³⁹ B R Agle, T Donaldson, R E Freeman, M C.Jensen, R K.Mitchell and D J Wood ‘Dialogue: Towards Superior Stakeholder Theory’ (2008) Business Ethics Quarterly, Vol 18, Issue 2, 153-190

⁵⁴⁰ Wood (n 492) 159-162

⁵⁴¹ K Phillips, *American Theocracy: The Peril And Politics Of Radical Religion, Oil And Borrowed Money In The 21st Century* (New York: Viking 2006)

⁵⁴² A Sen, *On Economic Inequality* (Oxford: Oxford University Press 1997)

⁵⁴³ D J Wood, J M Logsdon, P G Lewellyn, and K Deavenport, *Global Business Citizenship: A Transformative Farework For Ethics And Sustainability Capitalism* (Armonk, NY: M.E.Sharpe 2006)

else'.⁵⁴⁴ George Lakoff says that 'the Chicago school neo classical economics is actually a socio political agenda based upon values that emphasis self-reliance over community health, discipline over nurturance and suffering consequences over creating opportunities'.⁵⁴⁵

The ongoing debate surrounding the ethics of commercial strategies based purely on profit maximisation and the interests of shareholders has become increasingly relevant in recent years following numerous corporate collapses and scandals. Many of the aspects being called into question are global, such as the concentration of power in the hands of multinational global players, the legitimacy of European and American companies' business practices in the Third World and the way that companies deal with their customers and competitors. There are, however, also internal aspects that are in need of review such as staff management, corporate decision-making structures and commercial objectives.

In addition to this, there is growing criticism of the economic and materialistic nature of our values and thinking.⁵⁴⁶ One reason for this is that economic theories are based mainly on the construction of models and this seems to be an increasingly unsuitable method of describing 'reality'. Another reason is that the limitations of economic solutions are becoming ever more apparent.⁵⁴⁷

It is thus argued that to counter this particular practice of determining economic and financial policies which are devoid of value based concepts, issues of ethics can only be successfully amalgamated into the overall corporate sector through looking to the stakeholder and the CSR perspective, which encourages different stakeholders to be

⁵⁴⁴ B Ehrenreich, *Nickel And Dimed: On (Not) Getting By In America* (New York Metropolitan Books 2001)

⁵⁴⁵ G Lakoff, *Moral Politics; What Conservatives Know That Liberals Don't* (Chicago: University Of Chicago Press 1996)

⁵⁴⁶ W Hutton, *The State We're In* (Johnathan Cape, London 1995)

⁵⁴⁷ Zimmerli and Assländer (n 483)

a part of the corporate strategy both at the macro and the micro level.⁵⁴⁸ It does this whilst also making the corporation more socially and ethically aware and responsible.⁵⁴⁹ According to Walther Zimmerli and Michael S. Assländer:

Because business and entrepreneurial action is determined by economic constraints, the economic decision-making process is dominated by the need to ensure stability and growth while aiming at making a profit, consolidating market position and constantly increasing shareholder value. This demand for economic rationality dominates other aspects of economic action.⁵⁵⁰

Following from this, the CSR literature pursuant to business ethics ideals takes as the starting point of their critique of the neoliberal theory Milton Friedman's article in the New York Times which stated that the only social responsibility of a corporation is to increase profits for its stockholder.⁵⁵¹ Friedman was responding to the vastly growing and important conception of CSR, which on Earth Day in April 1970 became a verifiable concept in business and legal circles, forever to be etched into Anglo-American business practices.⁵⁵² The ensuing confusion of what a corporation stood for in the 1970s and the 1980s was perfectly summed up by Professor Lawrence Mitchell:

[N]o institution other than the state so dominates our public discourse and our private lives.... [C]orporations make most everything we consume. Their advertising and products fill almost every waking moment of our lives. They give us jobs, and sometimes a sense of identity. They define communities, and enhance both our

⁵⁴⁸ M T Jones 'Instrumental Stakeholder Theory: A Synthesis Of Ethics And Economics.' (1995) *Academy Of Management Review*. 20 (1), 404-437

⁵⁴⁹ Jones, Felps and Bigley (n 499)

⁵⁵⁰ Zimmerli and Assländer (n 483)

⁵⁵¹ 'The Social Responsibility Of Business Is To Increase Its Profits,' *N.Y. Times Mag.*, Sept. 13, 1970, Available At <http://www-rohan.sdsu.edu/faculty/dunnweb/Rprnts.Friedman.Dunn.Pdf> Or www.ethicsinbusiness.net/case-studies/the-social-responsibility-of-business-is-to-increase-its-profits.

⁵⁵² D M Branson, 'Corporate Governance "Reform" And The New Corporate Social Responsibility' *University Of Pittsburgh Law Review*, Vol. 62:605

popular and serious culture. They present the investment opportunities that send our children to college, and provide for our old age. They fund our research. Individually and collectively, though, large corporations' presence may also harm us: They pollute our environments. They impoverish our spirits with the never-ending messages of the virtues of consumerism. They provide a living, but often not a meaning. And sometimes they destroy us; our retirement expectations are unfunded, our investment hopes are dashed, our communities are left impoverished. The very power that corporations have over our lives means that, intentionally or not, they profoundly affect our lives.⁵⁵³

According to Freeman,⁵⁵⁴ the social movements of the 60s and the 70s compounded with other such liberal movements like civil rights, consumerism and women's rights to give rise to the socially aware and responsible corporation. The academic movement was led by Post⁵⁵⁵ and complemented by the likes of Sethi,⁵⁵⁶ Votaw⁵⁵⁷ and Preston.⁵⁵⁸ The movement can be seen as still continuing strong in both the stakeholder-oriented and the CSR literature.

The literature on CSR has widely influenced the stakeholder debate. According to Johnson 'social responsibility in reference to firms concerns the balancing of a multiplicity of stakeholder interests'.⁵⁵⁹ Additionally, Davis enunciated that 'social responsibility begins where law ends',⁵⁶⁰ which in essence meant that social

⁵⁵³ L E.Mitchell *Progressive Corporate Law* (Westview Press, 1995)

⁵⁵⁴ Freeman (n 500)

⁵⁵⁵ 'Research In Business And Society: Current Issues And Approaches.' Presented At Aacsb Conference On Business Environment/Public Policy And The Business School Of 1980s, Berkley, 1981

⁵⁵⁶ P Sethi, *Up Against The Corporate Wall* (P Englewood Cliffs: Prentice Hall, Inc 1971)

⁵⁵⁷ D Votaw and P.Sethi. *The Corporate Dilemma: Traditional Values Nersus Contemporary Problems* (Englewood Cliffs: Prentice Hall Inc 1974)

⁵⁵⁸ L Preston *Research In Corporate Responsibility And Social Policy*, Volume 1., 1979. Greenwich: Jai Press

⁵⁵⁹ H L Johnson, *Business In Contemporary Society: Framework And Issues*. (1971). Belmont, Ca: Wadsworth.

⁵⁶⁰ Davis (n 472)

responsibility is something that is above and beyond the normal legal relationship in the company that includes taking into consideration other stakeholders and not merely existing fiduciary duties.

The amount of influence that a corporation has in a given economy has grown exponentially, as has the number of stakeholders in a given corporation. This has resulted in the modern corporation becoming more of a social institution rather than a pure economic institution. This change of character has also forced changes in methods of governance.

Thus if examined closely, the CSR and stakeholder forms of governance are the practical implementations and manifestations of the much wider business ethics school of philosophy.⁵⁶¹ Another important contribution by the business ethics school has been to directly target the conception of the agency theory and the finance model of governance that has been dominated by the shareholder primacy conception. The shareholder primacy model, as already discussed, posits that the corporation's sole aim is to increase the overall income for the shareholders at all costs. Therefore, the business ethics and CSR models state that one of the major flaws of the agency theory is that it does not take into consideration issues of ethics when dictating the overall company and corporate strategy at both the macro- and the micro-level.⁵⁶² The agency theory, according to business ethics proponents, concentrates solely on the profit maximisation of a company which renders ethical issues as merely peripheral.

⁵⁶¹ A Kitson and R Campbell, *The Ethical Organization* (London: Macmillan 1996)

⁵⁶² T A Kochan and S A Rubinstein, 'Toward A Stakeholder Theory Of The Firm: The Saturn Partnership,' (2000). *Organization Science*, 11(4): 367-386

External stakeholders can influence organisational survival and prosperity since they often view CSR programs as a measure of the trustworthiness of an organisation.⁵⁶³

Thus, CSR initiatives tend to increase the relationship of trust between the business and the community, and this can translate into economic and social benefits in the form of a more loyal customer base, less stringent regulations, less public relations issues, less legal claims and a more effective marketing strategy

It is also acknowledged that whenever a company implements CSR policy, ethical issues will inevitably arise. However, instead of taking this particular issue as a drawback, the organisation can methodically work through these issues and convince the major stakeholders of their viability and win approval of the regulatory bodies.⁵⁶⁴ This, in turn, will result in lower monitoring costs and thus be economically feasible for the corporation in the long run.

Porter and Kramer put the issue of long-term versus short-term profits into perspective by emphasising that companies have to change their focus towards the social setting in which they act and interact because '[e]conomic, social and environment goals with a long-term perspective are not independent or in conflict in spite of the fact that they can be contradictory in the short-term.'⁵⁶⁵

Levine also highlights managing risks as a main benefit of CSR in the short-term:

[w]hy implement a CSR program? In short, to manage risks and to ensure legal compliance, since companies may be exposed to a variety of legal and reputational

⁵⁶³ R Phillips, *Stakeholder Theory And Organizational Ethics* (San Francisco, CA: Barrett-Koehler 2003)

⁵⁶⁴ D Llewellyn 'The Economic Rationale for Financial Regulation.'(1999) The Occasional Paper Series No. 1. London, Financial Services Authority (FSA)

⁵⁶⁵ M E Porter, Kramer and R Mark 'The Competitive Advantage of Corporate Philanthropy' (December, 2002) Harvard Business Review , 5-16

risks if they do not have adequate social compliance or corporate social responsibility/sustainability programs in place.⁵⁶⁶

CSR is defined as ‘a program of actions taken to reduce externalised costs or to avoid distributional conflicts. It is an institution that has evolved in response to market failures, a Coasian solution to some problems associated with social costs’.⁵⁶⁷ Thus, CSR can be looked at ‘as an effort to take actions which reduce the extent of externalized cost’.⁵⁶⁸ On the other hand, Beltratti emphasised the importance of CSR by highlighting the weaknesses and shortcomings of the shareholder model and the agency theory: ‘CSR is an attempt to escape profit maximization in the recognition that agency problems and incomplete contracts undermine the basic idea of shareholders supremacy.’⁵⁶⁹

Keeping the stakeholder point of view as the main focus, Koehn has defined corporate governance as ‘the art of governing in a principled fashion so as to maximize the welfare of the company and its relevant stakeholders’.⁵⁷⁰ He further added that

[t]he agency problem involved in corporate governance would thus be better addressed not only with legal safeguards and economic incentives, but also with trust building institutional practices, governing well would thus ultimately mean acting in a trust worthy fashion. No company will ever succeed in the long run if it is

⁵⁶⁶ B Thorston, LucLaevan and R Levine ‘Finance, Firm size and Growth’ (2008) *Journal of money, credit and banking* 40:1379-1405

⁵⁶⁷ G Heal, *Corporate Social Responsibility. An Economic And Financial Framework* (Columbia Business School December 2004)

⁵⁶⁸ Ibid Geoffrey Heal 41

⁵⁶⁹ A Beltratti ‘The Complementarity Between Corporate Governance And Corporate Social Responsibility’ (2005) *The Geneva Papers Bocconi University* 30, (373-386)

⁵⁷⁰ D Koehn, ‘What Can Eastern Philosophy Teach Us About Business Ethics?’ (1999) *Journal Of Business Ethics*, Vol 19, No 1, 1999

not trusted by its customers, employees, suppliers, advisors, shareholders and other important stakeholders.⁵⁷¹

This assertion shows the importance of having good ethical practices in running a corporation, which helps to build a strong case for justifying the stakeholder and CSR method of governance.

Koehn's assertion regarding businesses being run on a relationship of trust can be construed as an attempt to reconcile the characteristics of ethics into business. Virtue has been used interchangeably with ethics by philosophers like Aristotle, who wrote that '[e]thics deals with the whole range of manifestations of virtue, from "fine actions" to "character"- which enable a state's citizens to aspire to the good life'.⁵⁷² The philosophical debate surrounding the fulfilment of man's desire in society asks the question: are ethics enough to ensure happiness or fulfilment in a society? Sisson has argued that although ethics play a major role in the life of humans, external or material goods play an equally important part and so ethics without an external motivator like economics/commerce are meaningless.⁵⁷³

Confirming this, writers like Freeman have also argued that 'ethical issues are as much a part of economic and business as accounting, finance, marketing and management'.⁵⁷⁴ This statement supplements his assertion that the separation thesis⁵⁷⁵ as understood by academics is 'bankrupt discourse', meaning that the conception of business as amoral is wrong. Another way to look at the separation thesis is from the point of view of the agency theory, which would presumably take

⁵⁷¹ Ibid Kohen 13

⁵⁷² W D Ross (Translated) *Nicomachean Ethics By Aristotle 350 Bc*, (Oxford University Press, USA ,July 9, 1998)

⁵⁷³ Sisson (n 338) 57

⁵⁷⁴ Freeman and Werhane 'Business Ethics: The State Of The Art' (1999) *International Journal Of Management Reviews*, Reviews; Vol 1

⁵⁷⁵ The underlying understanding in the business circles including academics about the meaning of the separation thesis is that business and ethics are completely apart and have nothing to do with each other.

the following stance: the management of the company is to be concerned with only the profit maximising function of the company at all costs, ignoring or rejecting all other claims whether ethical or not. Conversely, the stakeholder theory holds that rather than there being one goal of a business (profit maximisation), there are a multitude goals of which profits are merely one. Other goals include the pursuit of a common good, building a relationship of trust amongst the stakeholders and establishing a sound crisis management policy that would affect many stakeholders and society generally, whether direct or indirect.

The purposes of both virtue and business activities in a society are therefore similar, i.e. to pursue human fulfilment and happiness and eventually to pursue the common good for society in general.⁵⁷⁶ Thus, the immediate objective of a corporation is to provide the conditions that make the acts of virtue possible so that pursuits of goals such as the common good and formation of sound crisis management policies for the stability of the financial system are facilitated, keeping in view all relevant stakeholders.⁵⁷⁷ This is similar to the point of view in Islamic business ethics regarding trusteeship (*kifalah*) where the interests of the society are given precedence over that of the individual and thus in the long term the individual is benefited as part of the collective.⁵⁷⁸ The individual is taken as a trustee for the economic resources that he owns as the vicegerent of God and subsequently of society, revealing a major similarity between the stakeholder standpoint and the Islamic theories.⁵⁷⁹

Therefore, ethics and economy are dependent upon each other. Sisson has argued that based on the Aristotelian teachings ‘all economic activity (firms, corporations)

⁵⁷⁶ Argandoña (n 479)

⁵⁷⁷ Jones, Felps, and Bigley (n 499)

⁵⁷⁸ Please refer to chapter 3 of this thesis for a more detailed discussion of this concept.

⁵⁷⁹ Refer To Chapter 3 Of This Thesis Pg 10

should function under the guidance of ethics, which is the practical science of acts of virtue (which is considered to be supreme human excellence)'.⁵⁸⁰ He then continues by stating that 'the economy has as its mission to facilitate the practices of virtue or ethics by establishing favourable material conditions amongst the citizens of a state'.⁵⁸¹ As espoused by the concept of *falah* in the Islamic business ethics model,⁵⁸² the pursuit of profit cannot be taken as the end in itself for any model. This 'end' is the fulfilment of human happiness and pursuit of common good for the society, which cannot be achieved without the presence of ethics. Building upon this particular argument, it can be seen why the shareholder model of corporate governance fails to fulfil these requirements and why the stakeholder model and the CSR model of corporate governance are the best possible models of corporate governance for all IFIs as will be observed in the next section.

5. The Stakeholder theory and its suitability for Islamic financial institutions

The stakeholder theory addresses the argument of regarding the question of in whose favour the corporation should be run. But the underlying issue with the concept itself is the matter of defining who is to be considered a stakeholder. Having discussed the different views on who should or should not be included as a stakeholder for any organisation, the only definition that is satisfactory theoretically as well as practically is that given by Thomson,⁵⁸³ and subsequently endorsed by Freeman,⁵⁸⁴ where the stakeholder concept denotes 'those groups which make a difference', or

⁵⁸⁰ Sisson (n 338) 58

⁵⁸¹ Sisson (n 338) 59

⁵⁸² chapter 3 pg 13 of this thesis

⁵⁸³ J Thomson, *Organisation in action* (Mc Graw Hill 1967)

⁵⁸⁴ Freeman (n 459) 41

more formally: 'A stakeholder in an organization is any group or individual who can effect or is affected by the achievement of the organization's objectives.'⁵⁸⁵

By using this particular definition of a stakeholder, the manager will see different groups involved directly or indirectly with the organization as having a stake in the organisation. The stakeholder concept will therefore denote legitimacy by demanding that managers give due weight to the concerns of these groups in order to positively affect the direction of the organisation.⁵⁸⁶ This would more clearly define what managers should spend in terms of time and resources on these stakeholders without any regard to the appropriateness of their demands. This results in giving legitimacy to the demands of all stakeholder and not only the shareholders.⁵⁸⁷

Freeman and other academics that support the stakeholder theory as a corporate governance model have provided their endorsement because they are of the view that the consequences of not adopting this approach may very well lead to the company suffering from legal action, regulation compliancy costs and damaging regulation and the loss of market share to foreign competitors who can satisfy stakeholder needs.⁵⁸⁸ This shows how important the integration of the stakeholders is in running an efficient and successful company both strategically and legally.⁵⁸⁹ The other point that is made clear is the role that the government plays if stakeholders' concerns are not taken into account. A very strong case of regulating corporations by the government and quasi-government agencies can be made under the stakeholder approach because the government is also considered a stakeholder due to the direct/indirect effects of their policies. Consequently, the overall policy that the

⁵⁸⁵ Freeman (n 459) 46

⁵⁸⁶ T M Jones and A C Wicks 'Convergent Stakeholder Theory.' (1999) *Ficadeini' of Management Review* 24 (2), 206-221

⁵⁸⁷ Freeman (n 459) 46

⁵⁸⁸ Freeman (n 459) 26

⁵⁸⁹ Jensen (n 498)

government would implement for the business environment will have to reflect these stakeholder concerns and ensure compliance with those policies by the corporations.⁵⁹⁰

This has been seen in the recent financial crisis when governments exercised minimal intervention in supervising important industries like banking and financial services. This non-interventionist role of governments led to banks being run merely for profits and ‘projected’ (artificial and superficial) profits manufactured by unethical practices.⁵⁹¹ As long as the bank’s financial situation on paper was strong and the shareholders were getting dividends, there was no inquiry into the way those profits were being made. Government agencies declined to intervene until the collapse was all but inevitable. This non-interventionist policy led to the downfall of the wider economy simply because banks and other financial institutions have become such an integral part of the economy and their failure had a domino effect on other industries.⁵⁹² Thus, Freeman and other academics who propagate the stakeholder theory as the principal strategic and planning practice for the modern corporation - whether a bank or otherwise - are right to do so. Their assertions are valid because the inherent risk of making firms accountable solely to shareholders is very high.⁵⁹³ One of the reasons for the antagonism towards the company being responsible solely to the shareholders is the belief that they may not be interested in anything other than their share prices going up. Further, they may also be underqualified to absorb and decipher all of the complex information regarding the market, thus increasing the chances of the managers running the corporation for their

⁵⁹⁰ B A Ackerman and A Alstott, *The Stakeholder Society* (Yale University Press, New Haven, CT 1999)

⁵⁹¹ J Armour and J A McCahey, *After Enron Improving Corporate Law And Modernizing Securities Regulation In Europe And The US* (Hart publishing 2006)

⁵⁹² P O Mulbert ‘Corporate Governance Of Banks’ (2009) [Http://Ssrn.Com/Abstract=1448118](http://Ssrn.Com/Abstract=1448118), Working Paper N:130/2009

⁵⁹³ Phillips (n 543)

own whims and wishes, again bringing doubt to the hypothesis of the rational shareholder.⁵⁹⁴

One of the primary advantages of using the stakeholder concept to govern IFIs is its roots in an ethical ideology which is expected in business dealings. As proposed by Domènec Melé and Manuel Guillén:

[a] stakeholder approach grounded in ethical theories presents a perspective of corporate social responsibility in which ethics is central. This represents clear progress in the understanding of the integration of ethics into strategic management.

In fact, there is a connection between strategic thought and ethical reasoning.⁵⁹⁵

According to Freeman, the term ‘stakeholder’ must be able to encompass a wide range of potential claimants.⁵⁹⁶ As previously discussed, any individual or group who may affect or who may be affected by the actions of the organisation shall be considered a stakeholder. According to this definition, it must also be taken into account that the concerns of such a group or individual should not be neglected as they may negatively influence the achievement of an organizations goal. Building on this concept of stakeholder, a strategic management point of view will thus take into account the capability of an organisation to manage the relationships with its specific stakeholder groups in a practical or action-oriented way.⁵⁹⁷

As already discussed, it was Freeman whose seminal work popularized the stakeholder concept from a mere afterthought to a plausible theory for management

⁵⁹⁴ Jensen (n 498)

⁵⁹⁵ Domènec Melé and Manuel Guillén ‘The Intellectual Evolution Of Strategic Management And Its Relationship With Ethics And Social Responsibility’ (2006) Working Paper Wp No 658 October 2006, Electronic Copy Of This Paper Is Available At: [Http://Ssrn.Com/Abstract=960663](http://Ssrn.Com/Abstract=960663)

⁵⁹⁶ Freeman (n 459)

⁵⁹⁷ Freeman (n 459) 47

and policy.⁵⁹⁸ Freeman was of the view that the business environment globally has always ‘dealt with non-market stakeholders’ with the internal and external changes taking place especially post-WWII, within Anglo-American corporations.⁵⁹⁹ With globalisation taking its stride, the simple explanation of the firm as merely a resource conversion entity was no longer appropriate. According to Freeman, the internal changes that have changed the face of the business environment include those relating to owners, customers, employees and suppliers.⁶⁰⁰ The interaction of these and other factors (internal and external) necessitates a change in policy at the management and governmental level. The external changes that Freeman refers to are the expansion of federal, state and local government business-related activities. Increases in foreign competition, consumer activism and the growth of special interest groups like unions, environmental protection groups and gun control groups have also played a significant role in shaping the way that the firm is looked at from a stakeholder’s perspective.⁶⁰¹ These changes all require a revamp of the current strategic and policy-based decision-making processes to integrate stakeholder theory into firms’ overall structure not as outsiders but as integral parts of the process.

It can be said that there are three levels at which we can divide an organisation as far as its ability to manage its relationship with the stakeholder is concerned.⁶⁰² This will give a better understanding of how and when to interact with a particular group of stakeholders. These are set out as follows:

The first level is the rational level;⁶⁰³ the most basic level on which it is decided which groups and individuals can actually affect or be affected by the organisation

⁵⁹⁸ Freeman (n 459)

⁵⁹⁹ Freeman (n 459)

⁶⁰⁰ Freeman (n 459)

⁶⁰¹ Freeman (n 459)

⁶⁰² Freeman (n 459) 52

⁶⁰³ Freeman (n 459) 54

achieving a particular purpose. Hence, there is a need to identify specific stakeholders on this first level. This analysis will be detailed as regards the particular influence of a group and how that influence may arise.⁶⁰⁴ This strategy will be important from both a managerial and a legal point of view, thus the overall strategy will have to take into account the underlying legal relationships between the company and the stakeholders and how these relationships may be influenced adversely or positively.⁶⁰⁵ The other issue is deciphering what constitutes a “stake”. Freeman considers any influence, whether monetary, political or social, as sufficient.⁶⁰⁶ There is also a further category of stake which may be seen as a middle ground between the traditional conception of stake as equity and Dill’s definition of a kibitzer, called the ‘market stake’ by Freeman.⁶⁰⁷

The other definition of ‘stake’ that Freeman has offered is characterised by means of the power or influence that the stakeholder has over the organisation. This ‘power’ can be divided into three further types of powers; namely voting powers (owners have this), economic power (customers and suppliers) and political power (the government).⁶⁰⁸ These categories are not mutually exclusive because according to Freeman, these powers and players overlap each other’s boundaries and may interfere with each other’s powers without awareness that they are doing so. But from a managerial or organizational point of view these differences may be vital for developing strategy. This is specifically true for the investment account holders (IAHs) in the IFIs who are major stakeholders, being investors and depositors, but have neither the protection of the traditional depositors nor the authority of the

⁶⁰⁴ I M Jawahar and G L McLaughlin ‘Toward A Descriptive Stakeholder Theory: An Organizational Life Cycle Approach.’ 2001 Academy Of Management Review 26(3): 397-414

⁶⁰⁵ C W L Hill and T M Jones ‘Stakeholder-Agency Theory.’ (1992). Journal of Management Studies, 29: 131-154

⁶⁰⁶ Freeman (n 459) 59

⁶⁰⁷ Freeman (n 459) 60

⁶⁰⁸ Freeman (n 459) 63

traditional shareholders.⁶⁰⁹ This leaves them vulnerable to the abuse of power by management, which in essence means that IFI need to establish such a legal framework and governance structure where by the IAHs are given adequate power and authority. Thus it is even more important for IFIs to focus on a corporate governance model which is stakeholder-oriented.⁶¹⁰ The drawback of this particular level is that there may actually be a problem when the stakeholder perceptions are not in line with those of the organisation. This introduces the need to explore other levels of analysis.

The second level is the organisational/process level. In order to manage their relationship with stakeholders, the management will generally rely on set procedures and patterns, and these procedures will give us a better understanding of which processes are actually more useful.⁶¹¹ This level of interaction between the management and stakeholders is vital to IFIs' governance model because of their inherent nature of having a diverse range of stakeholders being involved in their operation including, *inter alia*, normal depositors, IAHs, shareholders, employees and the SSB.⁶¹² Some of these stakeholders - being unique to the Islamic finance industry - require more attention because of the number of stakeholders that are involved an IFI are more than their conventional counterparts, thus making it even more imperative for IFIs to be governed via a stakeholder model of governance.⁶¹³

The third level is the transactional level.⁶¹⁴ This tries to explain how managers carry out transactions with the stakeholders, how managers interact and what resources

⁶⁰⁹ Iqbal and Mirakhor (n 495)

⁶¹⁰ Luca Errico and Mira Farhbaksh 'Islamic Banking: Issues in Prudential Regulation And Supervision' (1998) IMF Money And Exchange Department, WP/98/30, Working Paper

⁶¹¹ Freeman (n 459)

⁶¹² M A A Sarker 'Islamic Business Contracts, Agency Problem and the Theory of The Islamic Firm' (1999) International Journal Of Islamic Financial Services, 1 (2)

⁶¹³ E B Satkunasegaran 'Corporate Governance and The Protection Of Customers Of Islamic Banks,' (2003) International Islamic Banking Conference 2003. Prato, Italy

⁶¹⁴ Freeman (n 459) 69-71

they allocate towards that interaction. At this level, managers will be carrying out many different types of transaction with different stakeholders, and these transactions will result in many tangible strategic and managerial decisions being taken accordingly. For example, the more common transactions would be with the government, employees, the media and the consumers, all of which will determine how the company will react to different issues. In the case of an IFI, there will be additional categories of stakeholder like the SSB, IAHs and the two-tiered regulatory bodies (one for regulating the *sharia* aspects and another for regulating the normal functioning of an IFI as a corporation). Thus, this level of interaction between the IFI and the concerned stakeholders will be an important feature of the stakeholder model of governance.⁶¹⁵

According to Freeman, a good company would be expected to understand this interaction process and adapt accordingly.⁶¹⁶ For example, when a significant amount of consumers become unhappy about a certain aspect of a company or its product, the company which responds well to that particular group of stakeholders will be considered a success. Similarly, an organisation that understands and responds accordingly to the demands or reservations of the stakeholder map as a whole will be more aware of the external environment of the company.

Freeman also notes that the problem with understanding and implementing the stakeholder philosophy is not an external one, rather than there being problems with the stakeholders the actual battleground lies within the company.⁶¹⁷ It is the lack of managerial understanding of the stakeholder concept and its likely implications on the business environment as a whole that leads to the lacklustre interaction with the

⁶¹⁵ W Grais and M Pellegrini 'Corporate Governance and Shariah Compliance In Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054

⁶¹⁶ Freeman (n 459) 85

⁶¹⁷ Freeman (n 459) 74

stakeholders. Also, so long as managers remain ignorant to this issue, the business community as a whole will remain stagnant and unresponsive to changing practices both externally and internally. This is even more pronounced for the Islamic financial industry, wherein managers have to be aware of the dual nature of the entity and have to respond accordingly. In essence, this means that the management will have to take decisions which will be acceptable by the shareholders and create wealth whilst also complying with the *sharia* precepts and focusing on the societal needs of a number of stakeholders.⁶¹⁸

Furthermore, Freeman was of the view that the best way to implement the stakeholder approach is by means of ‘voluntarism’ since the change has to come from within.⁶¹⁹ One major concern for Freeman was that the cost of other means of implementing this approach are too high as there are many stakeholders involved and to cater for all of them externally is next to impossible. Freeman asserted that the only solution is that managers become aware of the stakeholders around them and act accordingly.⁶²⁰ Instead of trying to hide from the impending issues, they should voluntarily embrace and work with them and incorporate them into their strategies and day to day dealings. It is thus argued that in such a case, a meta-regulatory framework with a mixture of both voluntarism as well as some enforcement powers by a supranational regulatory authority is the most optimal way of regulating IFI internationally.

Friedman and Miles argue that the most common way of classifying stakeholders is to ‘consider groups of people with a distinguishable relationship with corporations: shareholders, customers, suppliers and distributors, employees and local

⁶¹⁸ Iqbal and Mirakhor (n 495) 43-63

⁶¹⁹ Freeman (n 459) 75

⁶²⁰ Freeman (n 459) 75

communities'.⁶²¹ Another issue, according to Friedman, is whether the stakeholders are to be confined to those that are crucial for the achievement of corporate objectives, or if they include any entity that is directly or indirectly affected by the company's operations or actions. The latter definition may be too wide, as it may result in difficulties identifying whether a particular individual is a stakeholder, since the effects of a business in modern economies are widely felt. However, from an Islamic finance point of view, corporate objectives should normatively be towards contributing to societal wellbeing and achieving distributive justice. Consequently, the list of potential stakeholders has to be longer than those accepted by conventional financial institutions.⁶²²

Thus, Freeman and Bowie (and Reed in his works with Freeman) have divided this definition further into two different parts: the wide definition (which encompasses all those indirectly and directly affected by the workings of a corporation) and the narrow definition (which focuses on the distinguishable legal relationships that a company may have with its core stakeholders).⁶²³ Accordingly, for IFIs, the categories of stakeholders falling within both these classifications are the IAHs, the SSB, the employees,⁶²⁴ the depositors, the shareholders, the regulators,⁶²⁵ their customers⁶²⁶ and if extended slightly further society as a whole may also form a

⁶²¹ Friedman and Miles (n 464)

⁶²² M H Karnali, *Maqasid Al-Shari'ah: The Objectives Of Islamic Law* (Islamic Research Institute, International Islamic University Islamabad, Islamabad 1999)

⁶²³ R E Freeman, *Stakeholder Theory Of The Modern Corporation* in T.L. Beauchamp And N E Bowie (Eds) *Ethical Theory And Business* (7th Edn. Upper Saddle River, NJ: Pearson/Prentice-Hall) : R E Freeman and D L Reed, 'Stockholders And Stakeholders: A New Perspective On Corporate Governance' (1983), *California Management Review*, 25/3:88-106

⁶²⁴ Sallam and Hanafy (n 285)

⁶²⁵ S Archer and R Abdel Karim, *Islamic Finance: The Regulatory Challenge* (Wiley publishers 2007)

⁶²⁶ Satkunasegaran (n 593)

group of stakeholders that the IFI owes a duty to indirectly and directly under the *sharia* rules.⁶²⁷

Another area of concern in the definitional debate is the unclear role of the managers. Some writers have considered them as stakeholders but others have treated them more significantly and considered them as the main focal point of the organisation.⁶²⁸ The significance of the role of managers in this debate cannot be underestimated and it is very important to actually distinguish what the managers do in the corporation in general. The role of the managers has to be viewed from the perspective of the stakeholders as to how they manage their relationship with them i.e. how well they cater to the needs of the stakeholders and how well they integrate them into their vision of the company and the corporate policy.⁶²⁹ It is thus argued that management of the IFI has to be stakeholder-oriented, not only for the economic benefit of the IFI but as a matter of legal and religious duty as espoused by the basic principles of Islamic economics.⁶³⁰

Another important factor for defining the stakeholder is to identify which of them have a fiduciary relationship, and accordingly those who are owed fiduciary duties may be classed as primary stakeholders and those who aren't are classed as secondary stakeholders.⁶³¹

Donaldson and Preston have distinguished between influencers and simple stakeholders.⁶³² However, there may be an overlap in this distinction; there may be some who influence the corporation and have no stake (such as the media), whilst

⁶²⁷ Naqvi (n 156)

⁶²⁸ Jensen and Meckling (n 349)

⁶²⁹ Freeman (n 459)

⁶³⁰ M U Chapra and H Ahmed, *Corporate Governance In Islamic Financial Institutions* (Islamic Development Bank and Islamic Research and Training Institute. Jeddah 2002)

⁶³¹ A L Friedman and S Miles, *Stakeholders: Theory And Practice* (Oxford: Oxford University Press 2006)

⁶³² Donaldson And Preston (n 362) 83

similarly there may also be some who may have a stake but no influence (such as job applicants), and then there may further still be those who are both stakeholders and influencers like the stockholders.⁶³³

Another justification for employing the stakeholder concept as the underlying ethos is based on the premise that all stakeholders provide a source of capital implicitly and explicitly by means of the different services and activities that they carry out. Blair, Etzioni, and Schlossberger present this justification in their defences of why stakeholders should form an integral part of the company.⁶³⁴ This is most pertinent for the IAHs in an IFI who do actually contribute capital for the IFI but are overlooked as being owed a legal duty as understood under conventional law. This is why IFIs need to have a structure in place which caters to this particular class of stakeholders specifically.⁶³⁵

Blair has stated that the current conception of shareholders as capital providers for businesses is a concept that has its roots in history, dating back to when corporations were involved in setting up railway lines and operating canals.⁶³⁶ It was in these scenarios that the initial investors were relied upon for initial investment and thus they were the largest stakeholders in the corporations' operations. According to Blair, this conception of the stakeholder is now redundant as investment has moved away from being reliant upon capital intensive wealth generation to the incorporation of more intangible assets, where the 'skills and the ability of the workforce and the ability of the organization as a whole to put those skills to work for customers and clients' is now considered investment as much as capital

⁶³³ Friedman and Miles (n 611) 12-13

⁶³⁴ M M Blair (n 363/ n 368) : A Etzioni, *The New Golden Rule. Community And Morality In A Democratic Society* (New York: Basic Books 1996) ; A Etzioni 'A Communitarian Note On Stakeholder Theory' (1998) *Business Ethics Quarterly*, 8/4:679-91; E Schlossberger 'A New Model Of Business: Dual- Investor Theory', (1994) *Business Ethics Quarterly*, 4/4: 459-74

⁶³⁵ This will be discussed in more details in the next two chapters

⁶³⁶ Blair (n 363)

contributions.⁶³⁷ Thus, the validity of the shareholders having a legal and moral claim based on their capital contribution is no longer as certain, further weakening the viability of the shareholder primacy view.

Schlossberger has gone a step further, propagating that all businesses have a fiduciary duty towards stakeholders, not because of any underlying social or implicit contract, but because stakeholders are a type of shareholder that has invested capital in the business.⁶³⁸ This is so because all businesses have two types of capital; ‘specific capital’ and ‘opportunity capital’ (this is well-suited for the Islamic banking model of IAHs and shareholders), the latter of which is attributable to the stakeholders, rendering them a shareholder of sorts whilst the former type is conventional equity capital attributable to shareholders and partners. This ‘opportunity capital’ is provided by the society as a whole by way of material infrastructure, educational systems, monetary systems, policing and also the infrastructure of knowledge. Schlossberger argues that this capital is present and available to all businesses and whether they exploit it or not is up to them, but that since society does in fact provide these facilities they are to be considered a category of shareholders regardless.⁶³⁹

Following from this argument, ‘society is a shareholder in every business venture, though not the same type of shareholder as stockowners’.⁶⁴⁰ Thus, every stakeholder is simultaneously a sort of shareholder and every business venture in a capitalist nation is both privately and publicly owned concurrently.⁶⁴¹ This means that corporations ‘have the same kind of fiduciary obligation to society as to

⁶³⁷ Blair (n 363)

⁶³⁸ Schlossberger (n 614) 86

⁶³⁹ Schlossberger (n 614) 71

⁶⁴⁰ Schlossberger (n 614)

⁶⁴¹ Schlossberger (n 614) 95

stockholders’.⁶⁴² This can, in strategic and policy terms, be read as saying that the responsibility of the corporation to take into account the interest of non-stockholding shareholders is not merely a responsibility and a constraint on the corporation and its management; rather, it is a part of the ‘corporate objective’. Hence, according to Friedman and Miles,⁶⁴³ the compelling nature of this argument by Schlossberger lies with its provision of that ‘a criterion for deciding on what degree of ownership is required of government’.⁶⁴⁴ Thus, this idea is based on the concept of property ownership, which cannot be considered an absolute right that allows one to do as one pleases at the detriment of others. Furthermore, it becomes a part of the governmental obligation to establish a variety of public/private ownership relationships and the more public the business is, the heavier it will demand opportunity capital and then consequently the higher the obligations are to the opportunity investors. This idea of individual actors not having an absolute right in property ownership is very similar to the idea of property ownership in Islamic finance literature and draws a very apparent parallel to the Islamic financial ethos,⁶⁴⁵ giving the idea of stakeholder theory credence in both Islamic literature as well as conventional corporate governance literature.⁶⁴⁶ It can then further be argued that IFIs need to be governed under a stakeholder-oriented model and not the *en vogue* neoliberal shareholder primacy model.

6. Stakeholder Theory and ethics: legal duties vs moral duties

Freeman refused to accept there was any singular stakeholder theory; rather, stakeholder theory is merely a genre.⁶⁴⁷ This view of his is motivated by what he

⁶⁴² Schlossberger (n 614) 62

⁶⁴³ Friedman and Miles (n 464)

⁶⁴⁴ Schlossberger (n 614)

⁶⁴⁵ For a detailed discussion refer back to chapter 2 of this thesis

⁶⁴⁶ M U Chapra, *Islam and The Economic Challenge* (Leicester, The Islamic Foundation 1992)

⁶⁴⁷ Freeman (n 368)

calls 'pragmatism' as this then 'leads to one of many ways to blend together the central concepts of business with those of ethics'.⁶⁴⁸ It was Freeman who took the stakeholder concept from being a simple discussion point to a practical strategy that could be employed both at the company and the state level. Thus, Freeman can easily be called the 'father' of the modern day stakeholder concept.

Since Freeman's conception of the stakeholder is normative, spelling out how corporations should be governed and how managers should act, it can be argued that the stakeholder theory encompasses the normative ethical/moral question. It does so by defining the relationships between all the stakeholders and how they are managed ethically, keeping in view the requirements of society in general, and thus translates theory into practice by giving concrete suggestions as to how to go about implementing these ethical standards.⁶⁴⁹

According to Freeman, one of the major reasons of the scepticism about business ethics is the fact that the managers in the corporation are deemed to be agents of the company and this makes business ethics a part of a broader question of agents' responsibility to companies in general. This also helps us understand what kind of a duty is owed to the company by the managers.⁶⁵⁰ This posits the question whether this agency relationship of the managers with the company as a whole overrides other moral rules and issues like the responsibility of the managers towards the larger stakeholder community, as opposed to being focused purely on increasing the value of the company stock.⁶⁵¹

Since the morality or ethics of a company can be taken to mean the aggregate of its individual actors like the managers and stockholders, the question that can then be

⁶⁴⁸ Freeman (n 368)

⁶⁴⁹ Freeman (n 368)

⁶⁵⁰ Freeman (n 368)

⁶⁵¹ Blair (n 366)

asked is: what does a company aim to achieve? Or more deliberately, as Goodpaster and Donaldson have asked, what is the nature of corporate responsibility?⁶⁵² The answer according to the neoliberal economist and agency theory proponents is simply ‘to increase its profits as long as it stays within the rules of the game.’⁶⁵³ But for business ethics, CSR and stakeholder proponents the answer is completely different. They take profit maximisation as one of the aims of the corporation and do not consider it as the end in itself. For them, the end is the common good of the society, whereby corporations consider their social and ethical responsibilities whenever taking actions and pursuing strategies; something which is resonant in Islamic finance literature.

Friedman’s point of view is based on the rational choice theory, which states that all rational human beings will make choices which will further their own interests, which in the case of the company and its stock holders and managers is to maximise the value of the company.⁶⁵⁴ The rational choice theory has already been proven to be based on the wrong presumptions by writers like Wood,⁶⁵⁵ Mitnick,⁶⁵⁶ Arrow,⁶⁵⁷ and Zimmerli and Assländer.⁶⁵⁸ The argument given by the neoliberal proponents against the stakeholder and business ethics point of view is this: why should or why would a stockholder/investor put in money to benefit someone else like the other components of society (the ‘indirectly affected stakeholders’)? One of the counter

⁶⁵² K E Goodpaster ‘The Concept Of Corporate Responsibility’ (1983) *Journal Of Business Ethics*, 2(1): 1-22; T Donaldson, *Corporation And Morality* (Prentice-Hall 1982)

⁶⁵³ T Friedman ‘The Social Responsibility Of Business’ (1970) *New York Times Magazine*, Sept 13th 122-126

⁶⁵⁴ Friedman (n 633)

⁶⁵⁵ Wood (n 492)

⁶⁵⁶ Mitnick (n 492)

⁶⁵⁷ Arrow (n 494)

⁶⁵⁸ Zimmerli and Assländer (n 483)

arguments to this rational choice theory comes in the shape of the Integrated Social Contract Theory (the ISCT) as proposed by Donaldson and Dunfee.⁶⁵⁹

ISCT has its roots in the writing of Thomas Hobbes, who said that people tacitly consent to join together in societies and at least tacitly agree to laws and regulations on their behaviour, so that they can live in harmony and achieve their own ends in relation to others.⁶⁶⁰ Donaldson and Dunfee have taken this to mean that there are basic moral norms or 'hyper norms' that govern all social relations at both the macro- and micro-level.⁶⁶¹ Like all other segments of society, these norms are practiced at the company level as well. At the micro-level, however, there are free moral spaces in this regard which are to be fulfilled by the said organisation in line with macro-level norms. So long as the macro- and micro-level norms do not contradict each other, they will be acceptable.⁶⁶²

This can then translate to mean that at a company level the rational choice theory is not an absolute statement and ought to be qualified by norms both at the macro- and the micro-level. So, if a profit maximising company is not meeting its ethical and moral obligations it will no longer be an acceptable justification for acting in any particular fashion as is deemed necessary by the management of the company.⁶⁶³ However, according to Freeman even this conception of the ISCT does not completely solve the conundrum that faces the legal and business community at the micro-level. Accordingly, it is 'the stakeholder theory that bridges the gap by eliminating the macro/micro distinction'⁶⁶⁴ and it is argued that for an industry based

⁶⁵⁹ T Donaldson and T Dunfee 'Towards A Unified Conception Of Business Ethics: Integrative Social Contract Theory' (1994) *Academy Of Management Review*, 18(2), 22-284

⁶⁶⁰ R Tuck and M Silverthorne (Ed & Trans) ' Thomas Hobbes, *On The Citizen* (Cambridge University Press, Cambridge 1998 [1642]) and Edwin Curley (Ed) 'Thomas Hobbes, *Leviathan*' [1651/1668] (Hackett, Indianapolis 1994)

⁶⁶¹ Donaldson and Dunfee (n 639)

⁶⁶² Donaldson and Dunfee (n 639)

⁶⁶³ Donaldson and Dunfee (n 639)

⁶⁶⁴ Freeman (n 368)

on moral and ethical aspects like the Islamic finance industry, the stakeholder model for corporate governance is the best available. This is so because it fulfils all criteria of the Islamic economic and business ethos as well as providing modern IFIs with an acceptable mode of operation in all jurisdictions.

Stakeholder theory brings in the dual concept of values and morality working in a practical environment; something that both the individual moral point of view and the agency theory cannot offer. The agency theory focuses purely on one facet of the whole agent principal relationship of maximising profitability and value, whilst on the other hand the moral/ethical point of view only focuses on the values and normative issues of ethics regarding what a company ought to do without touching upon the practical aspects of the business environment.⁶⁶⁵ As Freeman puts it,

Stakeholder theory, by calling attention to the variety of roles that can be occupied by individuals all of whom have a moral stake in the organization, can thus provide a framework for understanding and explicating the possibility of conflict of values, of loyalty, of commitment and of interests.⁶⁶⁶

This stakeholder theory also then goes on to counter the argument that the corporation is 'soulless', by stating that the business or at least their managers behave in a way that safeguards the soul of the corporation.⁶⁶⁷ Thus, the corporation is given a value-laden soul which would and should take into account moral and ethical issues whenever conducting business. Clarkson has said that even though the concept of CSR is a good idea in theory, it is unworkable on a voluntary basis as the corporation cannot be expected to act benevolently unless they are either forced to or

⁶⁶⁵ N M Wijnberg 'Normative Stakeholder Theory and Aristotle: The Link between Ethics and Politics.' (2000) *Journal of Business Ethics*. 25, 329-342

⁶⁶⁶ R E Freeman 'Divergent Stakeholder Theory' (1999) *Academy Of Management Review*, 24: 233-236

⁶⁶⁷ Friedman and Miles (n 464)

the corporation sees a benefit in it for itself.⁶⁶⁸ Thus, CSR and stakeholder policy is only effective if combined with the regulatory and legal framework for enforcement. Otherwise, the idea becomes worthless apart from as a marketing tool. The best solution is therefore to combine the two solutions of having meta-regulations for enforcing CSR and the stakeholder concept.

The underlying idea of the firm being a ‘soulless’ corporation was the pretext to the stakeholder debate’s importance in both managerial and legal literature on the company. The alleged lack of the ‘soul’ in a corporation has been filled in by the value laden stakeholder concept, which is a moral theory regarding values being attributed to non-living beings. In this context, values are attributed to the company by virtue of the managers’ value judgements.

The stakeholder theory as promulgated by Freeman thus affirms the Islamic point of view regarding business activity having a moral and ethical foundation, at the same time questions the separation thesis by removing the distinction between descriptive roles of all the stakeholders, preferring to attribute normative roles to them (the stakeholders).⁶⁶⁹ The stakeholder theory also asserts that all stakeholders have an intrinsic value in running the company and therefore also removes the distinction between the moral/ethical and practical aspects of business.⁶⁷⁰ These two aspects of the stakeholder theory can thence be taken as arguments supporting the notion that the stakeholder theory is indeed the best method of reconciling the moral/ethical aspects of the company’s working with the practical aspects.⁶⁷¹ This assertion will hold true at both the macro- and the micro-level for the Islamic finance industry as

⁶⁶⁸ Clarkson (n 490)

⁶⁶⁹ Freeman (n 459); Iqbal and Mirakhor (n 495)

⁶⁷⁰ Argandoña (n 479)

⁶⁷¹ R Phillips, E Freeman and A C Wicks ‘What Stakeholder Theory Is Not?’ (2003) *Business Ethics Quarterly*, 13(4): 479-502

encompassing the value laden concepts that are embodied in the *sharia* rules regarding finance and economics.

It is also asserted that another important question needs clarification. That is, ‘what is the role of the company?’ This can best be answered by the help of the stakeholder theory. Freeman and Evans state that ‘the very purpose of the firm (and thus its managers) is to serve as a vehicle for coordinating stakeholder interests’, which is similar to the concept of financial intermediation in Islamic finance literature.⁶⁷²

This therefore serves as a solid foundational theory for the governance of Islamic financial institutions. Freeman then continues by saying that ‘[i]t is through the firm that each stakeholder group makes itself better off through voluntary exchange. The corporation serves at the pleasure of its stakeholders and none may be used as a means to the ends of another without full rights of participation of that decision’.⁶⁷³

This is also a notion which forms the basis of financial intermediation in Islamic financial literature, where business entities are deemed to be vessels through which the two main purposes of distributive justice are served. The first is the involvement of as many stakeholders as possible and the second is the discouragement of hoarding and interest-based transactions by encouraging society to form partnerships between those who have resources and those who have the ability to manage and act as agents (partnerships or the *musharaka* and *mudaraba* form of contracts). This way the wealth is circulated amongst society and hoarding and speculation are discouraged.⁶⁷⁴

This statement shows that all stakeholders not only have a moral claim but also a fiduciary and legal claim on the workings of the firm and thus the collective morality

⁶⁷² Freeman and Evans (n 368)

⁶⁷³ Freeman and Evans (n 368)

⁶⁷⁴ S Haron, *The Philosophy Of Islamic Banking* in A. Siddiqi, *Anthology Of Islamic Banking* (Institute of Islamic Banking And Insurance, London 2000a)

of the all the stakeholders involved in the process of decision-making in the corporation forms what may be termed the ‘morality’ of the corporation.⁶⁷⁵ It is this morality that would give rise to the ethical standards that the corporation decides to implement, and thus answers sceptics who question the role of ethics in business. It is thus inevitable to have ethics in a business no matter the size of the corporation.

Once it is established that the company owes fiduciary and moral duties to other components of society, it becomes easier to ensure compliance by outlining the standards expected. The contribution of the stakeholder literature in the field of corporate governance cannot be underestimated, since it clearly establishes and highlights any and all relationships that may exist between a firm and its partners.⁶⁷⁶

Furthermore, the field of CSR the stakeholder theory has contributed in two different ways; the first being the fact that stakeholder theory defines and outlines the importance of information channels in the relationship and secondly, the stakeholder theory highlights the importance of the role of the stakeholders in the corporation by conceptualising information as a crucial element allowing the organisation to manage its relationships.⁶⁷⁷

On the other hand, in conventional corporate governance literature it was the major concern about the big corporation being run from mere profits that prompted the government(s) and academics alike to respond with a requirement that the corporation be run not solely for the economic benefit of the stockholder, but that the corporation should be more socially responsible and consider a wider range of stakeholders when deciding upon a course of action.⁶⁷⁸ Hence, the concept of the

⁶⁷⁵ Gibson (n 497)

⁶⁷⁶ R E Freeman and W M Evan ‘Corporate Governance: A Stakeholder Interpretation’ (1990). *The Journal Of Behavioral Economics* 1, 9(4):3 37-359

⁶⁷⁷ Y Pesquex and S Damak-Ayadi ‘Stakeholder Theory In Perspective’(2005) *Corporate Governance*: 2005; 5, 2

⁶⁷⁸ Freeman (n 459)

stakeholder was born alongside the requirement that corporations act in a more socially responsible way. This is the reason that the stakeholder and CSR literature have somewhat similar underlying themes and ideas that are at times used interchangeably. Both derive their philosophical roots from the business ethics literature and are thus suitable governance and regulatory frameworks for the Islamic financial industry.

7. Common good and the stakeholder theory

Taking its cue from the domain of morality and religious ethics, Argandona has furthered the conceptual understanding of the stakeholder theory in light of what he calls the ‘common good’ concept, which according to him is the only economic concept that is based on religious rather than philosophical values.⁶⁷⁹ This concept is associated with natural law and Christian theologians like Saint Augustine and Thomas Aquinas. In drawing an analogy between this theory and the debate surrounding corporate governance, it is argued that the common good of the company ought to be to create the condition that will enable its members to achieve their personal goals. This means that the company will have achieved its own goals when the stakeholders achieve their respective personal goals. The common good obligations of the company extend ‘from the common good of the company itself to that of the local community, the country and all human kind, including future generations’.⁶⁸⁰ Under this theory, stakeholders seem to provide a transmission mechanism of different routes whereby company obligations move from the good of the company itself to that of society at the macro-level.⁶⁸¹ Again, according to Argandona, ‘to the extent that the company develops its common good, all will have

⁶⁷⁹ Argandona (n 479)

⁶⁸⁰ Argandona (n 479) 1099

⁶⁸¹ Friedman and Miles (n 464)

a share in it (although in different ways and different proportions)'.⁶⁸² Thus, the common good doctrine seems to propose the idea of social and distributive justice. Even though this idea of common good is a worthy manifestation of what a corporation should strive for, there are some difficulties when trying to translate theory into practice and this difficulty is seen clearly in the debate between the proponents of the stakeholder, business ethics, CSR and those that prefer shareholder primacy. To translate this concept into practice, many things may require clarification. For example, what is the underlying concept of common good? Does this concept transcend national boundaries? How many people in a society need to be considered before concluding that common good has been achieved?⁶⁸³ These are the kind of arguments that can only be countered by a system of regulation and intermediation which can categorically take into account the moral, ethical and religious values of business.⁶⁸⁴ It is consequently argued that the only plausible and pragmatic answer can come from a stakeholder-oriented approach towards business.⁶⁸⁵

To further this argument, writers like Murray have asked a further question about the role of the corporation, the answer of which will determine how the corporation is to be run.⁶⁸⁶ The question that he poses is whether we should look at an organisation such as a corporation or a bank 'as a social organism meeting human needs of the many (society)'⁶⁸⁷ or as 'an impersonal mechanism for financial processing, creating wealth for the few'.⁶⁸⁸ These questions can be used to define

⁶⁸² Argandoña (n 479) 1098

⁶⁸³ Argandoña (n 479)

⁶⁸⁴ J Dawkins and S Lewis 'CSR In Stakeholder Expectations: And Their Implication For Company Strategy.' (2003) *Journal of Business Ethics*. 44 (2), 185-193

⁶⁸⁵ Donaldson and Preston (n 362)

⁶⁸⁶ David Murray, *Ethics and Organization* (London: Koganpage 1997)

⁶⁸⁷ Ibid Murray

⁶⁸⁸ Ibid Murray

and outline the corporate governance debate and resolve the issues surrounding the stakeholders and the CSR debate. Business ethicists like Collier and Roberts have argued for an interrelation between ethics and corporate governance issues, and state that ethics form an integral part of the corporate governance debate.⁶⁸⁹ They further say that in the corporate governance debate the role of the stakeholder theory is indispensable because it is the stakeholder concerns that answer the questions raised in the context of managerial decision-making.

The interplaying role of corporate governance and ethics in practice ensures that managers take decisions that minimise risk and maximise opportunities for both the business and society. The business managers' ethical decisions thus aim to increase value for both, and this solves one of the major conflicts in the modern day corporations; between a company making profits and acting responsibly towards society and its non-investor stakeholders (or in short, the pursuit of common good). The government also plays a significant role in ensuring that these corporate governance issues are well addressed and issues pertaining to ethics are taken into account by enforcing regulation and laws.⁶⁹⁰ Sternberg summarises the argument by saying that business ethics are essential for good corporate governance because it is of value to all corporations big and small, since it is valued by all the stakeholders involved in these corporations and as a result good corporate governance actually helps in the pursuit of common good at both the macro- and the micro-level.⁶⁹¹

Even though common good is a moral/ethical concept, it is wrong to assume that there is no uniform answer to what common good is in a society. For business ethicists and stakeholder proponents, the answer is simple: the achievement of

⁶⁸⁹ Collier, Jane and Roberts 'Introduction: An Ethic For Corporate Governance?'(2001) Business Ethics Quarterly 11, 1:67-71

⁶⁹⁰ Grayson, David and Adrian Hodges, *Everybody's Business: Making Risks and Opportunities in Today's Global Society* (London: Dorling Kindersley Ltd 2001)

⁶⁹¹ Elaine Stenberg, *Just Business: Business Ethics In Action* (London : Little, Brown and Co,1994)

distributive and socioeconomic justice⁶⁹² by a system whereby wealth and other social benefits are distributed uniformly.⁶⁹³ ‘Uniformly’ here does not necessarily mean that all people will have the same amount of wealth or benefit, but rather that the financial system should have such mechanisms whereby no one category of stakeholders are any worse off because of another category of stakeholder.⁶⁹⁴ For example, the shareholders of a corporation should not become better off at the cost of any other stakeholder e.g. the environment or the general public.⁶⁹⁵ In other words, the profit making of the corporation has to be kept in perspective of improving the external environment in which the corporation works.⁶⁹⁶ This aim is the manifestation of the Islamic financial ethos as well, and it is argued that stakeholder theory being based on business ethics and CSR theories is actually a manifestation of Islamic finance’s basic principles and ideology and thus they are completely compatible.⁶⁹⁷

It follows that the idea of common good is a moral constraint on all offices, including those of the managers,⁶⁹⁸ and the misuse of this power causes friction partly because of the failure to coordinate the self-interests of all the individual players in the organisation. This aggregate coordination is an example of how the stakeholder theory intends to look at the role of the managers, such as a role which involves the resolution of all conflicts of interest amongst the stakeholders involved

⁶⁹² Davies (n 475)

⁶⁹³ Carroll (n 488)

⁶⁹⁴ Clarkson (n 490)

⁶⁹⁵ A Crane, D Matten and J Moon ‘Stakeholders as Citizens? Rethinking Rights, Participation, and Democracy.’ (2004) *Journal Of Business Ethics* 5, 3(1-21):0 7-122

⁶⁹⁶ R A Phillips and J Reichart ‘The Environment as A Stakeholder? A Fairness-Based Approach’ (2000). *Journal Of Business Ethics*, 2 3(2):1 85-197

⁶⁹⁷ Z Sattar ‘The Ethics Of Profits In The Islamic Economic System: A Socioeconomic Analysis’ (1988) *The Islamic Quarterly*. XXXII (2), 69-76

⁶⁹⁸ H J Alford and M J Naughton, *Beyond The Shareholder Model Of The Firm: Working Toward The Common Good Of Business in S.A.* Cortright And M.J. Naughton, Eds., *Rethinking The Purpose Of Business. Interdisciplinary Essays from The Catholic Social Tradition*. Notre Dame, In: University Of Notre Dame Press, 23-47(2001)

in a particular decision.⁶⁹⁹ This decision-making process lies at the heart of the stakeholder theory, since it shows that no decision is taken to benefit one category of stakeholders at the cost of another. Following this, the managers are no longer to pursue profit maximisation of stockholders if that pursuit is in contradiction to the welfare of any other category of persons like creditors, employees, the environment and the community at large.⁷⁰⁰

Viewed from another angle, we see that the pursuit of the common good renders the managers as agents not merely for the shareholders but rather for all of the stakeholders thus making them fiduciaries of the entire firm and its stakeholders.⁷⁰¹

As a fiduciary, the duties of disclosure and loyalty are owed towards the corporation as a whole and not only to the shareholders. This duty of the manager is greatly distorted when he works only for the economic benefit of the shareholders.⁷⁰² The sole pursuit of profit is the main reason for the rejection of the agency and shareholder primacy theories by the stakeholder theorists as well as the business ethics school, who believe that the pure pursuit of profit by managers has led to many corporate governance and regulatory failures in the recent past.⁷⁰³ Thus, it can be argued that the idea of the common good demands the inclusion of the 'public good' (*Maslahah*) in the interests of those who have the power to decide (the regulators and policy makers) and this should form the basis for regulatory

⁶⁹⁹ Freeman (n 459)

⁷⁰⁰ R Phillips, *Stakeholder Theory And Organizational Ethics* (San Francisco, CA: Barrett-Koehler 2003)

⁷⁰¹ Bo Enquist, Mikael Johnson and Per Skålen, 'Adoption Of Corporate Social Responsibility – Incorporating A Stakeholder Perspective' (2006) *Qualitative Research In Accounting & Management*, Vol. 3 Iss: 3, 188 - 207

⁷⁰² Jones (n 528)

⁷⁰³ J Mccahery, Sol Picciotto and C Scott, *Corporate Control and Accountability Changing Structures And Dynamics Of Regulation* (Clarendon Press. Oxford 1993)

framework for an industry like the IFI which is based on religious and moral principles.⁷⁰⁴

It is therefore argued that the stakeholder model of corporate governance is a practical manifestation of business ethics and CSR philosophies and is strongly opposed to the self-justifying ends of pure profit making of corporations as supported by the shareholder primacy theory of corporate governance. These philosophies are in line with the ethos and aims of Islamic finance (*Maqasid al Sharia*) and business and are the most suitable models for the Islamic financial industry.

8. Conclusion: Business ethics, the Stakeholder theory and the pursuit of Common good as part of the regulatory conundrum for IFIs.

Sociological and economic researchers who propagate the concept of CSR draw an analogy between the social and economic controls prevalent in society to ensure adherence to social norms so that the rights of the individual are not violated. Within the corporate context, the concepts of CSR and the stakeholder theory ensures a basic level of participation for all the stakeholders in the company according to their respective stakes. These checks, enforced by the stakeholder theory, form a very important ‘antidote to the toxic effects of the pursuit of economic self-interest’⁷⁰⁵ and at the same time address most of the false neoliberal presumptions built into the shareholder model. Furthermore, Donna Woods summed up the arguments by stating that

⁷⁰⁴ P Koslowski, *The Common Good Of The Firm As The Fiduciary Duty Of The Manager in G.J.(Deon)* Rossow and Alejo Jose G.Sison (Ed) *Global Perspectives On Ethics Of Corporate Governance* (Palgrave Macmilan, 2006)

⁷⁰⁵ Wood (n 492)

In this era of globalization, it is imperative that we all hold corporations accountable for meeting their economic goals in socially responsible and ethical ways. Capitalist business is the most efficient way we know of to organize an economy, but free markets, without any government intervention or countervailing powers, are *not the most effective* way to achieve societal goals such as environmental sustenance, human rights and justice. Corporation that cannot earn profits legally, ethically and responsibly do not deserve to survive, nor can our planet afford for businesses to continue to treat their stakeholders as just another ‘environmental factor’ to be ‘managed’.⁷⁰⁶

It is this line of argument that resonates with the Islamic finance jurisprudence, espoused by both contemporary and traditional writers, that propagates an ethical and social conception of financial intermediation with principle-based checks and balances proposed by religious writings. This social and ethical conception of financial intermediation can be furthered practically by a principle-based meta-regulatory framework that caters for the stakeholder ideals at the international level to ensure proper compliance with *sharia* principles (*Maqasid*) for all IFIs.

It is thus argued that the value laden concept of a stakeholder-oriented corporate governance framework is logical as well as imperative for IFIs. This is further necessitated by the operational paradigm and unique features of modern IFIs in the shape of the SSB as an additional supervisory body, having a class of investor/depositors (IAHs) who are both investors akin to conventional shareholders as well as categorised as depositors, having to work within religious and moral values that underpin the operational as well as ideological basis of the industry. Rather than having shareholders as the sole owners, the Islamic finance industry

⁷⁰⁶ Wood (n 492) 161

needs to take into account a wider range of stakeholders when operating as financial intermediaries; this is in line with the conceptual fundamentals(*Maqasid*) of Islamic economics such as *falah* (the wellbeing of society), *adalah* (justice), the promotion of brotherhood and unity, economic freedom and distributive justice. Consequently, promotion of the principles of Islamic finance via modern IFIs requires a regulatory framework which can cater to the stakeholder nature of IFIs whilst remaining true to the religious ideals of *maqсад sharia* (the objectives of *sharia*). It is argued in the later chapters that these goals and aims can only be achieved if a principle-based meta-regulatory framework is instituted, which allows some operational freedom to individual IFIs but also maintains a compliance mechanism whereby the stakeholders involved are assured that Islamic financial institutions are actually ‘Islamic’ in both substance and form, thereby maintaining the essence of Islamic economics and finance’s social and ethical outlook.

CHAPTER 6 MODERN DAY IFI PRACTICES AND FINANCIAL INSTRUMENTS

1 Background

The next two chapters of this thesis are concerned with the application of *sharia* rules to the modern day IFIs, with a focus on the three basic modes of financial intermediation: *mudarabah*, *musharaka* and *murabahah* contracts. These form the basis of all other financial instruments used by modern IFIs and therefore these three contracts will be viewed from the perspective espoused by the Islamic finance literature and it will be questioned whether the use of these three forms of intermediation contracts, as practiced by modern day IFIs, are true to Islamic finance ideals (*Maqasid al sharia* of financial intermediation). In addition, the corporate governance and regulatory problems presented by these modes of intermediation shall be assessed to see whether their current use is in line with the stakeholder nature of the Islamic finance ethos. The other aspects that will be looked at include the issues surrounding the *sharia* supervisory boards (SSB) and the different categories of account holders that modern IFIs have. These aspects of the SSB and the account holders are particularly important from the corporate governance point of view as these two unique features (amongst others) merit a purely stakeholder-oriented corporate governance mechanism. It is asserted that the current practice of IFIs is anything but stakeholder oriented, rather they – due to the dual reasons of international competitive pressure and a vacuum in the regulatory compliance and enforcement framework - have succumbed to the neo liberal shareholder-oriented model of corporate governance. This poses a systemic regulatory and governance risk for the IFI as an industry, especially to the stakeholders involved, and thus a

positive effort is needed to ensure that IFIs move towards a stakeholder-oriented corporate governance model (both in theory and in practice) to hold true to the ethical and moral ideals (the *Maqasid*) of financial and economic Islamic teachings.

2. Introduction

The modern day IFI relying on the aforementioned principles⁷⁰⁷ of Islamic finance and economics utilises traditional *sharia*-compliant contracts making them unique in international financial and banking circles. This uniqueness is compounded with the fact that in recent time both Islamic finance as a whole and IFIs in specific have become increasingly popular in Islamic countries and non-Islamic Jurisdictions alike such as the UK, other European countries and Africa.⁷⁰⁸ This chapter looks at the most commonly used contracts which form the basis of financial intermediation in modern day IFIs as well as other unique features like the presence of the *sharia* supervisory boards, the Islamic window operations and the presence of investments account holders which are not present in conventional financial institutions.

The bases of modern day Islamic financial institutions are the basic partnership forms applying profit and loss principles called *mudarabah* and *musharaka*. In simple terminology, the *mudarabah* relationship between the bank and its stakeholders works in the form of a partnership whereby the investing party is called the *Rab-ul-Mal* (the owner of capital) and the other party is called the *mudarib* (the agent – although similar in certain aspects to the western concept of commercial agents, the relationship is not the same agency relationship as understood in western

⁷⁰⁷ In the previous chapters of this thesis, specifically chapter 1 and 2

⁷⁰⁸ M Iqbal and P Molyneux, *Thirty Years Of Islamic Banking: History, Performance And Prospects* (New York, Palgrave Macmillan 2005)

commercial law).⁷⁰⁹ This relationship can be structured in different ways to ensure that most needs of modern day banking are met while being compliant with the *sharia* principles relating to economics and finance. According to Vogel and Hayes, two principles are paramount: firstly, that the return on capital cannot be fixed and thus must be made as a proportion of profits; and secondly that capital (and not labour) is liable to the financial risks of the venture.⁷¹⁰ There are three basic methods of financial transactions that are used in modern day Islamic banking practices to form the core of financial intermediation: *bay al murabaha* (sale contracts), *mudarabah* (agency or trustee financing) contracts and *musharakah* (partnership) contracts along with their respective variations.⁷¹¹

3. The two-tiered *mudarabah* and islamic window operations

The modern day Islamic financial industry works on the basis of two models: the two-tiered *mudarabah* and the two windows model. There is also a third model of financial intermediation; the Islamic window that is predominantly established in the conventional financial institution.⁷¹²

a. The two tiered model

The two-tiered *mudarabah* is the most commonly used model of Islamic financial intermediation.⁷¹³ Here, based on the traditional *mudarabah* contract(s), the IFI accepts the deposits from depositors (the *Rab-ul-Mal*) as investments, acts as a

⁷⁰⁹ S Haron and B Shanmugam, *Islamic Banking System: Concepts And Applications* (Kuala Lumpur, Pelanduk Publications 2001)

⁷¹⁰ Vogel and Hayes (n 17) 130

⁷¹¹ M T Usmani, *An Introduction To Islamic Finance* (Karachi, Pakistan, Idaratul Ma'arif 2000)

⁷¹² Z Iqbal and A Mirakhor, *An Introduction To Islamic Finance Theory And Practice* (Wiley Publishers 2007)

⁷¹³ M Ghazi 'Contemporary Corporate Finance: Modaraba Financing, An Appraisal' (February 1999), New Horizon, No. 84, 3-7

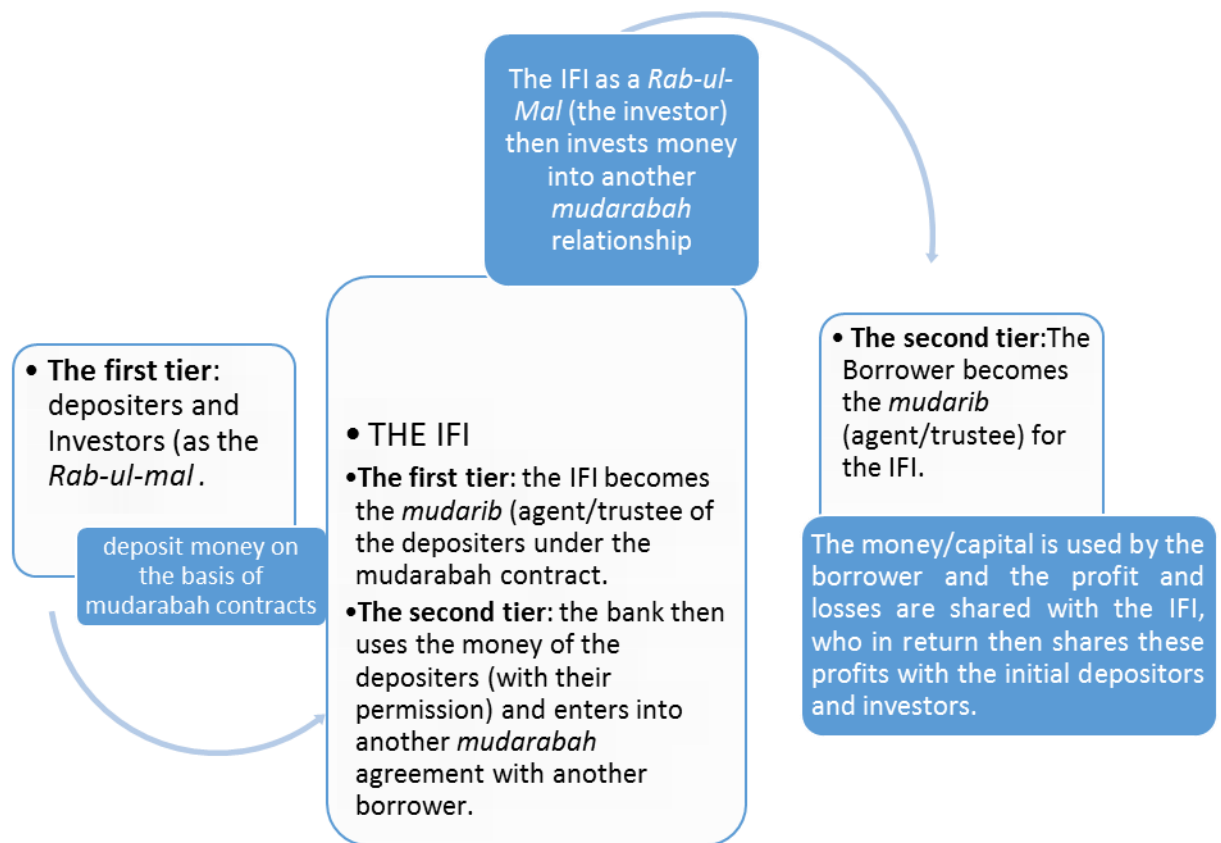
mudarib (agent) and on the basis of a profit and loss sharing contract invests the deposits into different investment schemes. Thence, the investors (depositors) are given back a pre-designated portion of profit if and when the IFI makes it.⁷¹⁴ However, it has to be remembered that there is no guarantee of any safeguard for the profits or even the basic deposit, since a guaranteed sum would amount to *riba* and *gharar* and render the operation non-compliant with *sharia*.⁷¹⁵ In the same IFI, a second tier *mudarabah* is executed, this time between the IFI as the provider of finance (the *Rab-ul-Mal*) and the entrepreneurs who take out funds to invest under a contract of *mudarabah* with a fixed percentage of return on profits of the IFI. In this way, the IFI is able to balance its risks and returns while maintaining compliance with the Sharia based contracts.⁷¹⁶ Based on the two-tiered *mudarabah* model of Islamic banking, the IFI's has three types of account holders: current account holders, unrestricted investment account holders (UIA) and restricted investment account holders (RIA).⁷¹⁷

⁷¹⁴ K Ahmad 'Islamic Finance and Banking: The Challenge and Prospects' (2000) Review Of Islamic Economics. 9, 57-82

⁷¹⁵ M U Chapra 'Why Has Islam Prohibited Interest: Rationale behind the Prohibition of Interest' (2000b) Review Of Islamic Economics. 9, 5-20

⁷¹⁶ S A Rosly, *Critical Issues On Islamic Banking And Financial Markets* (Author house 2005)

⁷¹⁷ A Ahamd 'Structure Of Deposits In Selected Islamic Banks' (1997) IRTI Research Paper No 48 (Islamic Development Bank, Jeddah)



THE TWO-TIERED MUDARABAH MODEL figure 1

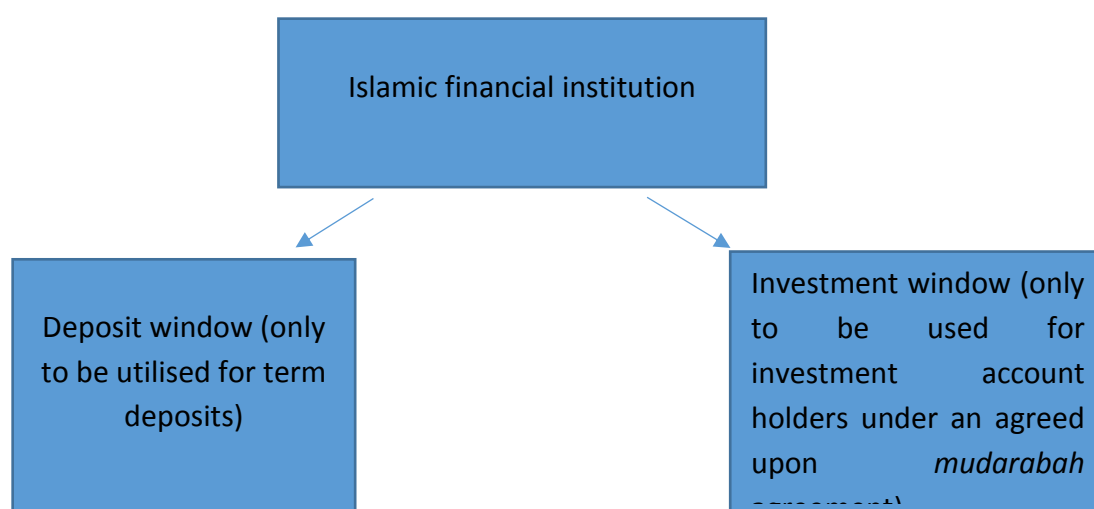
b. The two window model

The second model is called the two windows model. Here, the IFI divides its operation into two windows; one meant for pure demand deposits with no investment activities and the other is purely intended for investment purposes. The demand deposit works on the basis of *amanah* (trust/safekeeping) and is thus backed by a one hundred percent demand deposit reserve at all times.⁷¹⁸ This means that the IFI cannot touch this particular fund for anything because the deposit

⁷¹⁸ E B Satkunasegaran, 'Corporate Governance and The Protection Of Customers Of Islamic Banks' (2003) In International Islamic Banking Conference Prato, Italy

belongs to the depositors and not to the IFI. The IFI may however charge fees for this service of safe keeping and that is where the IFI covers its costs.⁷¹⁹ The second window is meant as a pure investment window and the depositors place their capital with the prior knowledge that the IFI will be utilising the funds for investments in other projects which may bear risks and profits. Therefore, utilising funds for investment purposes ensures that the IFI may diversify their investments and make profits for themselves as well as the depositors.⁷²⁰ Again, it has to be asserted that no fixed return is promised to the depositors of the investment accounts, as this would be akin to *riba* and *gharar*.⁷²¹ The utilisation of traditional Islamic contracts as a means to enhance profitability and compete with traditional banks has been a great success story for the IFI, though there are some governance and regulatory issues that still need to be addressed.

SIMPLE TWO WINDOW MODEL figure 2



⁷¹⁹ Iqbal and Mirakhor (n 692) 110-112

⁷²⁰ Simon Archer and Rifaat Ahmed Abdel Karim, *Islamic Finance The Regulatory Challenge* (Wiley Publishers 2007)

⁷²¹ Chapra (n 695) 5-20

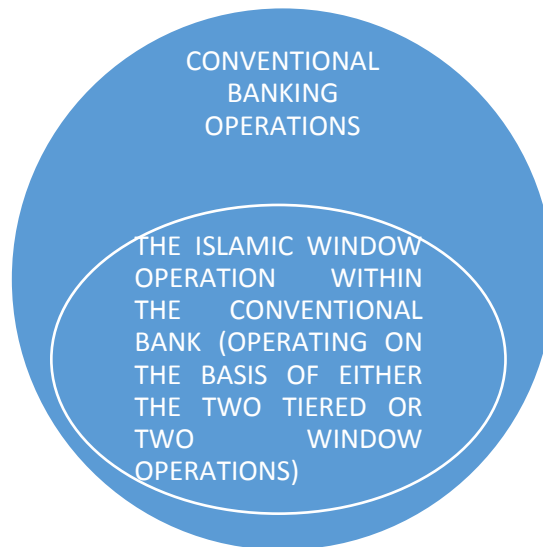
c. The Islamic window operation

The third model utilised by certain conventional financial institutions is to use either of these two models and open what is called an Islamic finance (or banking) window in their banks, where depositors wishing to utilise Islamic finance have the chance of choosing the Islamic window rather than the conventional interest bearing facilities.⁷²² These Islamic windows create certain systemic and ideological *sharia* compliance issues, the most important of which is the issue that the Islamic window model commingles resources and effectively eliminates any distinction between the conventional interest bearing funds and the *sharia*-compliant profit/loss funds.⁷²³ This criticism has prompted most conventional banks to open a *sharia*-compliant IFI as a subsidiary rather than operating a separate window within the same bank, which cannot legally commingle funds from the two different operations since the principal/parent and subsidiary are distinct legal entities in the eyes of the law.⁷²⁴

⁷²² D V Abdullah and K Chee, *Islamic Finance Why It Makes Sense, Understanding Its Principles And Practices* (Marshall Cavendish International 2010) 82-83

⁷²³ Archer and Abdel Karim (n 700)

⁷²⁴ W Grais And M Pellegrini 'Corporate Governance And Sharia Compliance In Institutions Offering Islamic Financial Services' (November 2006) World Bank Policy Research Working Paper 4054



THE ISLAMIC WINDOW OPERATION figure 3

It has to be emphasised that by utilising the aforementioned three models as operational models for IFIs, modern day Islamic banking can both be profitable and *sharia*-compliant as well as being able to attract customers who want returns on their deposits (investments) from the IFI whilst still adhering to *sharia*-compliant methods of financial activity.⁷²⁵

Another noteworthy aspect to be remembered is that the practice of utilising the two-tiered or two windows *mudarabah* is allowed jurisprudentially because of the risk sharing between the customer (the *Rab-ul-Mal*/ investor) and the IFI (the *mudarib*/agent) and vice versa, an aspect which we have seen to be an integral part of any economic activity if it has to be in line with *sharia*.⁷²⁶ The risk shared here is that the initial capital investors (depositors) and the returns are commensurate with the risk of loss that an investment may face.⁷²⁷ This risk of loss is borne by both the

⁷²⁵ R Wilson 'Islamic Finance and Ethical Investment' (1997) *International Journal of Social Economics*. 24 (11), 1325-1342

⁷²⁶ M T Usmani 'Sharia Governance Of Investment Funds' (Winter 1996/1997), *The American Journal Of Islamic Finance*, Vol. VII, No. 1, 13-20

⁷²⁷ Z Sattar 'The Ethics Of Profits In The Islamic Economic System: A Socioeconomic Analysis' (1988) *The Islamic Quarterly*. Xxxii (2), 69-76

initial depositors and the *Rab-ul-Mal* (the owner of initial capital) in relation to their investments in the IFIs (the *mudaribs* or the agents), and the banks themselves when they act as the *Rab-ul-Mal* (investors) and invest with other customers (agents or *mudaribs*) in the form of capital investment.⁷²⁸ As a result, this simple yet effective mechanism has helped the Islamic finance industry to be able to compete with conventional banks as well as being *sharia*-compliant. However, the workings of these three basic models for Islamic financial intermediation have their own corporate governance and regulatory issues which will be discussed in the next chapters.

Having explained the basic two-tiered *mudarabah*, it must be mentioned that modern day IFIs have developed almost a whole range of financial instruments and products on the basis of contracts that are deemed permissible under *sharia*. These contracts and instruments can be used to fulfil the needs of modern day commercial and consumer banking and are thus able to compete with conventional banks in many instances.⁷²⁹ These financial instruments can be categorised in many different ways. For example, these can be categorised as participatory and non-participatory instruments (which signify the role of the economic agents in the contracts), type-based contract categories like transactional, intermediation, financial and social welfare contracts⁷³⁰ and subject matter based categories of contract such as contracts of exchange, investment, security and charity.⁷³¹ Whichever method of categorisation is used, modern day IFIs primarily use the following financial instruments, with many overlaps between subject matter, modes of participation and the types of transactions. The most important and frequently utilised ones are

⁷²⁸ Please refer to the figure of the two tiered *mudarabah* contract above on page 5

⁷²⁹ Iqbal and Molyneux (n 688)

⁷³⁰ Iqbal and Mirakhor (n 692) 79

⁷³¹ T Al Diwany, *Islamic Banking And Finance: What It Is And What It Could Be* (1st Ethical Charitable Trust 2010) 127-178

mudarabah, *musharakah*, *murabahah*, *bay* (sale contracts of different types), *ijarah*, *salam* and *rahn*.⁷³² Most of the contract forms and instruments are agreed upon amongst scholars, but where differences arise, there is a fear of ‘*sharia* arbitrage’; an issue of governance which will be dealt with in the next chapters.

It is therefore pertinent to understand the basic workings of the three most commonly used financial intermediary contracts in modern day IFIs to better make sense of the working of modern day IFI’s.

4. *Mudarabah*

The *mudarabah* contract is considered a special kind of partnership between the investor and the entrepreneur or agent, where one partner (the investor or the owner of the capital) gives money to another (the agent) to invest it in a commercial enterprise.⁷³³ The investment comes from the first partner who is called a *Rab-ul-Mal* (the economic agent with the capital) whilst the management and work is the exclusive responsibility of the other, called a *mudarib* (an agent), who then manages the money given to him under a trust relationship.⁷³⁴ The *mudarabah* transaction can actually be historically traced back to the Prophet Muhammad himself, who acted as an agent of his wife Khadija’s business,⁷³⁵ even though there seems to be no explicit or implicit acceptance of this kind of a contract in either the Qu’ran or the *Hadith*. It is however understood to have been practiced widely in Arabia before and during the time of the Prophet Mohammad (PBUH), and has thus been accepted as valid.⁷³⁶

⁷³² F Al-Omar and M Abdel-Haq, *Islamic Banking: Theory, Practice and Challenges*. (London & New Jersey, Zed Book 1996)

⁷³³ Ghazi (n 693) 3-7

⁷³⁴ Ghazi (n 693)

⁷³⁵ Iqbal and Mirrakhor (n 692) 80

⁷³⁶ Diwany (n 711)

There are also some instances where the companions of the prophet used this contract and the Prophet Muhammad (PBUH) accepted the working.⁷³⁷

Another Arabic term used for *mudarabah* is that of ‘*qirad*’ which also signifies the capital being given to an entrepreneur for undertaking any economic activity.⁷³⁸ The *mudarabah* is further subdivided into two different types: *al mudarabah al muqayyadah* (restricted *mudarabah*) and *al mudarabah al mutlaqah* (unrestricted *mudarabah*).⁷³⁹

Based on the two-tiered *mudarabah* model of Islamic banking, modern IFIs offer three types of accounts: current accounts; unrestricted investment accounts and restricted investment accounts.⁷⁴⁰

The current accounts are basic deposit accounts for customers, and are based on the relationship of *amanah* (safe keeping) under the *sharia* jurisprudence and are simple demand deposits.⁷⁴¹ These accounts are always well capitalised and the IFI have no right to utilise any money from these accounts; they are to act as simple guardians of them. The depositors have no restrictions as to when and how much they want to withdraw from these accounts and thus these types of accounts hardly poses any major issues.

On the other hand, the restricted and unrestricted investment accounts are a unique feature of the Islamic financial industry and work on the basis of restricted or unrestricted *mudarabah* contracts and must be discussed in further detail to understand their working and the resulting governance issues.

⁷³⁷ Diwany (n 711) 162

⁷³⁸ Diwany (n 711) 162

⁷³⁹ M I Ashraf Usmani, *Meezan Bank's Guide To Islamic Banking* (Darul Ishaat Karachi, Pakistan 2007) 105

⁷⁴⁰ Ahamd (n 697)

⁷⁴¹ Satkunasegaran (n 698)

a. The restricted *mudarabah*

In the first kind of *mudarabah* - the restricted *mudarabah* - the *Rab-ul-Mal* as the capital investor specifically restricts the freedom of the agent with regard to the particular kinds of business, the particular place for business or both of these things that the agent (the *mudarib* - in this case the IFI) may invest the capital of the investor in, thus restricting them as agent of the entrepreneur to only those specific wishes. In such a case, the *mudarib* shall invest the money in that particular business or place only.⁷⁴² The repercussions for the *mudarib* for not complying with the wishes of the *Rab-ul-Mal* can be very risky in legal terms if the wishes of the investor are not adhered to (this will be discussed in more detail below), since under the restricted *mudarabah* the investor can hold the agent liable for any monetary loss that may accrue because of non-adherence to specific instruction.⁷⁴³

b. The unrestricted *mudarabah*

In contrast to this restrictive form of contract is the unrestricted *mudarabah* (*al mudarabah al mutlaqah*). Here, the *Rab-ul-Mal* allows full freedom to the *mudarib* to undertake whatever business he deems fit within the permissible form under the *sharia* rules.⁷⁴⁴ This difference between the restricted *mudarabah* and the unrestricted *mudarabah* are very significant because in the unrestricted variant the *mudarib* is only to contribute his labour and time into the economic activity and there is no financial obligation on his part even if the venture loses money,⁷⁴⁵ whereas in the restricted form the *mudarib* may be held liable if he deviates from the specific wishes of the investor.

⁷⁴² M K Lewis and L M Algaud, *Islamic Banking*. (Cheltenham, UK, Edward Elgar 2001)

⁷⁴³ Usmani (n 691) 32

⁷⁴⁴ Meezan Bank Guide (n 719) 107

⁷⁴⁵ Diwany (n 711) 163

So in essence, the only risk the agent is taking is that of lost time and effort, the only exception being where the *Rab-ul-Mal* can prove that the loss caused to the endeavour was directly attributable to the negligence or intentional act of the *mudarib*.⁷⁴⁶

These exceptions become very narrow when the agent is in a restricted *mudarabah*, and the burden on the investor becomes less; all he has to prove is that the *mudarib* did not adhere to the specific directions that had been set out for the contract.⁷⁴⁷ In case of an unrestricted *mudarabah*, the agent has the freedom to deal with the capital of the investor in a way he deems fit (insofar as they remain within the bounds of *sharia*). The *Rab-ul-Mal* cannot usually interfere in the *mudarabah* contract after the investment has been handed over to the *mudarib*,⁷⁴⁸ except in order to oversee their activities and in very exceptional circumstances work with *the mudarib* if he allows.⁷⁴⁹ The reason for this division between the two roles is to conceptually sever the *mudarabah* contract from the *musharakah* contract. The latter is actually a partnership contract and the roles of the contributing partners are very different from those espoused in a *mudarabah* contract.⁷⁵⁰

c. Conditions for a valid *Mudarabah* and possible governance issues

The *mudarabah* contract, as with other contracts under *sharia*, has to comply with certain conditions that make the agreement valid.⁷⁵¹ One of the basic contractual principles that the modern day IFIs utilise is the rule that the *Rab-ul-Mal* (the investor) may contract with more than one *mudarib* (agents) in a single transaction,

⁷⁴⁶ Usmani (n 691) 34

⁷⁴⁷ Iqbal and Mirakhor (n 692) 104

⁷⁴⁸ Ghazi (n 693)

⁷⁴⁹ Usmani (n 691) 36

⁷⁵⁰ Usmani (n 691) 37

⁷⁵¹ Diwany (n 711)

and the conditions of the *mudarabah* contract will apply to both of the *mudaribs* similarly.⁷⁵²

With regard to the types of investments that can be made by the *Rab-ul-Mal*, there are some differences in opinions amongst the *Hanafi* scholars and the other schools of thought.⁷⁵³ The *Hanafi* scholars opine that the only acceptable form of investment can be in liquid form, whereas the others deem other forms of investment acceptable as well.⁷⁵⁴ In modern practice, there seems to be no restriction as to the different types of investments that can be made. The only requirement is that the assets need to be evaluated properly according to the existing indices, and if the evaluation is not properly carried out, a *mudarabah* contract is deemed to be invalid.⁷⁵⁵

Despite the wide range of freedom available to the *mudarib* in dealing with the capital that has been given to him, there are some other restrictions that apply generally to the *mudarabah* contract. One major restriction is that the *mudarib* cannot, without the consent of *Rab-ul-Mal*, lend money to anyone else.⁷⁵⁶ This freedom of dealing by the *mudarib* with the investment of the *Rab-ul-Mal* is restricted also by the provision that the *mudarib* may do all that is normally, customarily and necessarily done in the course of that business.⁷⁵⁷ Anything that is above and beyond the normal course of business must be approved by the *Rab-ul-Mal* before being undertaken.⁷⁵⁸ There are also other restrictions for the *mudarib*; he is not authorised to keep another *mudarib*, a partner or mix his own investment in a particular *mudarabah* without the consent of *Rab-ul-Mal*.⁷⁵⁹

⁷⁵² M.Muslehuddin, *Banking And Islamic Law* (Islamic Book Service, New Delhi India 2008) 87

⁷⁵³ Omar and Abdel-Haq (n 712)

⁷⁵⁴ Diwany (n 711)

⁷⁵⁵ Usmani (n 691) 39

⁷⁵⁶ M Abdulrauf, *The Islamic Doctrine Of Economics And Contemporary Economic Thought* (American Enterprise Institution For Public Policy Research, Washington D.C. 1979)

⁷⁵⁷ Ahmad (n 694) 57-82

⁷⁵⁸ Usmani (n 691) 33

⁷⁵⁹ Mezan Bank Guide (n 719)

The other necessary condition for rendering a *mudarabah* valid is that both parties agree, at the beginning of the contract, on a definite proportion of the actual profit to which each of them will be entitled.⁷⁶⁰ In this regard, it is pertinent to mention that the *sharia* is silent in what proportion(s) should be prescribed between the parties. Nonetheless, it may logically be inferred that the underlying theme of this contract is the freedom of the contracting parties to enter into favourable terms for each of them so long as the terms are in line with the principles of the *sharia*.⁷⁶¹ The parties can share the profits in equal proportions, and they can also allocate different proportions for the *Rab-ul-Mal* and the *mudarib*.⁷⁶² However, in allocating these proportions of profits, the parties cannot provide for a set amount like a lump sum or a pre-designated percentage of the initial capital as that would amount to *riba*.⁷⁶³ The only proportion that can be agreed upon is that of the profit that is made over the initial capital. However, the parties can agree to set different proportions in the event of different situations. For example, the *Rab-ul-Mal* can specify that if the *mudarib* decides to work in line of business A the portion of the profit will be different than if he decides to work in line of business B.⁷⁶⁴

Furthermore, if the business has incurred losses in some transactions but has gained profit in others under the management of the *mudarib*, the profit shall be used to offset the loss at the first instance and then the remainder, if there is any, is distributed between the parties according to the agreed ratio. This gives the *mudarib* a chance to overcome certain losses.⁷⁶⁵ In the same stead, the *mudarabah* contract cannot specify any specific salary or guaranteed remuneration to the *mudarib* apart

⁷⁶⁰ Usmani (n 691) 37

⁷⁶¹ Ghazi (n 693)

⁷⁶² Mezan Bank Guide (n 719) 104

⁷⁶³ Iqbal and Mirakhor (n 692)

⁷⁶⁴ Usmani (n 691) 33

⁷⁶⁵ Diwany (n 711) 164

from the agreed proportion of the profit as determined at the start of the contract, thus differentiating the *mudarabah* contract from the normal agency contract.⁷⁶⁶

Another major underlying feature of the *mudarabah* contract is that once the contract is validly executed the *Rab-ul-Mal* has very limited rights to interfere in the working of the *mudarib* so that unless and until the *Rab-ul-Mal* has very serious apprehensions (such as serious misconduct or fraud) regarding the workings of the *mudarib*, he cannot interfere directly into the operations of the contract, essentially leaving him with little control over his investment.⁷⁶⁷ The rationale behind this rule is simply to allow the *mudarib* to work freely and earn his proportion of the profit which has been decided upon.⁷⁶⁸ The other major reason for this restriction is that if the *Rab-ul-Mal* is allowed to interfere unnecessarily in the workings of the *mudarib*, the contract starts to look more like a pure equity partnership (the *musharakah*) and not a *mudarabah*. Thus, it has been deemed necessary to have conceptual clarity in dividing the responsibility between the *Rab-ul-Mal* and the *mudarib*.⁷⁶⁹ However, as we shall see in the next chapter, such a distinction actually causes corporate governance problems in the modern day IFI and consequently poses a serious risk to their operation.

Keeping in view these specific conditions as derived from the traditional and contemporary literature, we will also see how these specific rules have a direct effect on the working of modern day IFIs, since these conditions dictate the different kinds of operation that they may undertake, as well as stipulating very clearly which contracts are permissible under the *mudarabah* type of financial intermediation.

⁷⁶⁶ Diwany (n 711) 165

⁷⁶⁷ Usmani (n 691) 38

⁷⁶⁸ Diwany (n 711)

⁷⁶⁹ Rosly (n 696)

d. Termination of *mudarabah*

The legal ramifications for the rules regarding the termination of the *mudarabah* contract are something that may cause some disconcertment for modern businesses and legal practitioners. This is because, according to the *Hanbali*, *Hanafi* and *Shafi* schools of thought, a *mudarabah* contract can be terminated at any time by either of the two parties,⁷⁷⁰ arguably bringing about some uncertainty in the working of modern day financial markets and raising serious governance and regulatory challenges. The only condition required for such a termination to be effective is to give notice to the other party.⁷⁷¹ However, the *Maliki* scholars take a more pragmatic and practical approach when they say that once the *mudarabah* contract becomes operational, the notice of termination is no longer effective if given unilaterally because the financial burden of such a cancellation would be unduly harsh for the *mudarib*.⁷⁷² This perspective has allowed IFI practitioners to bring in the required certainty into the institutions' operations.

It is asserted that when terminating a *mudarabah* by notice in the middle of its operation, the issue is raised of partitioning the remaining assets. According to Mulana Taqi Usmani

[i]f all assets of the *Mudarabah* are in cash form at the time of termination, and some profit has been earned on the principle amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the *Mudarabah* are not in the cash form, the *mudarib* shall be given an opportunity to sell or liquidate them, so that the actual profit may be determined.⁷⁷³

⁷⁷⁰ Usmani (n 691)

⁷⁷¹ Ghazi (n 693)

⁷⁷² Diwany (n 711) 164

⁷⁷³ Usmani (n 691) 34

Thus, it can be seen that the rules surrounding the termination of the *mudarabah* has far-reaching repercussions both financially and legally for the *Rab-ul-Mal* as well as the *mudarib*. It may also be asserted that these rules could even have a systemic negative impact on the whole Islamic finance industry, as the accompanying uncertainty is going to drive away many potential investors and depositors. Accordingly, it is argued in the next chapter that regulators have to address this issue.

As noted above, the practice of *mudarabah* is far from devoid of problems and these issues, when looked at in the context of modern day IFI practices, raise systemic governance and regulatory issues which can only be addressed by a regulator who looks to the principles of *sharia*(*the Maqasid al Sharia*), when determining the rules and regulations for the Islamic finance industry at a macro level. In turn, this raises the question of whether a national regulator who has no expertise in matters of *sharia* can ever be able to effectively implement a regulatory framework which allows for IFIs to work as *sharia*-compliant financial intermediaries. Thus, in the next two chapters a normative principle-based regulatory framework is suggested and it is argued that a stakeholder-oriented corporate governance approach may allow the Islamic finance industry to overcome some of the aforementioned problems.

5. *Musharakah*

The other type of contract that forms the basis of Islamic financial products in modern day IFIs is *musharaka* financing. In essence, this is partnership financing

that is used as an equity participation contract.⁷⁷⁴ Under this form of partnership contract, both profits and losses are shared according to a pre-determined formula. This forms the second type of basic financial instruments that are predominately used in modern day Islamic banking.⁷⁷⁵ The origin of the traditional *musharakah* is derived from the *Hadith*: ‘Allah will become partner in a business between two Mushariks until they indulge in cheating or breach of trust.’⁷⁷⁶ *Musharakah* is a word of Arabic origin which literally means sharing.⁷⁷⁷ The word is actually a derivative of the basic form of partnerships used in the pre-Islamic business environment called *Shirkah* (which if literally translated also means sharing). However, the legal and actual effects of the word *musharakah* are a combination of the word *Shirkah* and the intermediation contract of *mudarabah* discussed earlier.⁷⁷⁸ Such a combination forms a common characteristic of different financing contracts which contrast intermediation based contracts.⁷⁷⁹ The *musharakah* is an extremely fluid and multipurpose form of investment that is based on very basic principles which are compatible with the rules on profit and loss sharing and risk division between participants in a business venture.⁷⁸⁰ It is probably the rawest form of a financial contract that can be easily moulded and tweaked as and when required.⁷⁸¹ In today’s complex business and financial environment, it could be held to simply mean a joint enterprise in which all the capital and labour contributors share the profit or loss of the joint venture according to their contributions. It is a simple, albeit idyllic, alternative for interest-based financing, potentially having had a

⁷⁷⁴ M U Chapra and H Ahmed, *Corporate Governance In Islamic Financial Institutions* (Islamic Development Bank And Islamic Research And Training Institute Jeddah 2002)

⁷⁷⁵ Usmani (n 691)

⁷⁷⁶ As Quoted In T Usmani (n 691)

⁷⁷⁷ Usmani (n 691)

⁷⁷⁸ Ghazi (n 693)

⁷⁷⁹ Iqbal and Mirakhor (n 692) 91

⁷⁸⁰ Muslehudin (n 732) 95

⁷⁸¹ S Haron, *Islamic Banking: Rules And Regulations* (Kuala Lumpur, Pelanduk Publications 1999)

significant impact insofar as it can be said to have allowed the modern day Islamic financial industry to provide suitable alternatives for more conventional interest-bearing finance.⁷⁸² The *musharaka*, because of its simplicity and ease of use, has the advantage of having far-reaching effects on both production and distribution for general consumers and for stakeholders of the Islamic financial industry.⁷⁸³ However, despite its advantages, there is some scepticism surrounding their use due to the fact that *musharakah* may leave the capital contributors open to the risks of moral hazards and adverse selections.⁷⁸⁴

In modern banking practices, the *musharakah* conceptually embodies the relationship between the bank and the customer as an agreement to combine their financial resources to operate and manage a business undertaking as expressly laid out in the contract's terms and conditions.⁷⁸⁵ The importance that is attached to the *musharakah* contract (despite the possible risks attached to it) stems from the fact that Islam has only laid down basic principles for the *musharakah* relationship, leaving any other details to be worked out by the parties involved., provided that the terms and conditions do not breach *sharia* principles(the *Maqasid al Sharia*). Therefore, the *musharakah* can be used to cover most modern day financial needs.⁷⁸⁶ According to Taqi Usmani, the importance of *musharakah*, as an embodiment of the basic principles of *shari*-based finance and a practical alternative to interest-based financing, is that

[i]n the modern capitalist economy, interest is the sole instrument indiscriminately used in financing of every type. Since Islam has prohibited interest, this instrument

⁷⁸² K Ahmad, *Elimination of Riba: Concept And Problems* in K. Ahmad, *Elimination Of Riba From The Economy* (Institute Of Policy Studies, Islamabad, Pp. 33-63 1994)

⁷⁸³ Diwany (n 711)

⁷⁸⁴ Vogel and Hayes (n 17) 239

⁷⁸⁵ Abdullah and Keon Chee (n 702) 182

⁷⁸⁶ Usmani (n 691) 21

cannot be used for providing funds of any kind. Therefore, *musharakah* can play a vital role in an economy based on Islamic principles.⁷⁸⁷

6. Types of *Musharakah*

Since the term *musharaka* derives from the concept of *Shirkah* (partnership), it is believed that *musharakah* can by analogy be extrapolated from its basic form to encompass the different kinds of *Shirkahs* (partnerships or joint ventures).⁷⁸⁸ However, in the interests of conceptual clarity, the current discussion will be confined to the type of *Shirkah* that is most frequently referred to in the context of Islamic modes of financing called *Shirkat-ul-amwal* (mutual partnerships). The connotations of the term *musharakah* itself are more limited than the term *Shirkah* which is more commonly used in the Islamic jurisprudence.⁷⁸⁹ Thus, to clearly set out the context of the term *musharakah* with reference to *Shirkah*, the basic types of the latter need to be distinguished. In the terminology of Islamic *fiqh*, the *Shirkah* has been divided into two kinds:

- i. ***Shirkat-ul-milk***: The joint ownership of two or more persons in a particular property. The underlying legal principles are the joint ownership of any kind of property which could have come into existence either by mutual consent or by automatic operation of the *sharia* principles and Islamic jurisprudence regarding property division.⁷⁹⁰ This *Shirkat* will not be considered in the current discussion as it primarily deals with inheritance property and other kinds of joint ownerships of property and not specifically partnership by mutual contract, which is our concern in the context of modern day Islamic finance.

⁷⁸⁷ Usmani (n 691) 17

⁷⁸⁸ Omar and Abdel-Haq (n 712)

⁷⁸⁹ I A K Nyazee, *Islamic Jurisprudence (Usul Al-Fiqh)* (Islamabad, Islamic Research Institute Press 2000)

⁷⁹⁰ Meezan Banks Guide (n 719)

- ii. ***Shirkat-ul-aqd***. This is ‘a partnership affected by a mutual contract’⁷⁹¹ although for simplicity it may also be translated as ‘joint commercial enterprise’. *Shirkat-ul-aqd* is further divided into three kinds:
- iii. ***Shirkat-ul-amwal*** (or *sharikat inam*): where all the partners invest capital into a commercial enterprise. This partnership form encompasses mutual partnership and is the simplest and most widespread form of partnership used. In this form of partnership, each partner contributes a specific amount of property on the basis that each partner may deal in the property of the partnership. Therefore, each partner operates as a principal for his own share and as an agent for the other partner(s) as long as the action as the agent are done in accordance with the permission of the other partner(s).⁷⁹² In addition, profits are distributed in accordance with the partnership agreement, and the losses that are borne are divided in accordance with the contribution of each partner to the capital. Under *sharia* however, it is not allowed for one partner to guarantee the obligations of another, except to the extent that a partner acts outside his approved capacity as an agent to become liable to any other partner.⁷⁹³
- iv. ***Shirkat-ul-A'mal***: this is a contract based on providing a service jointly. The resulting fee that is charged is distributed amongst the partners according to a pre-determined agreed ratio. This a great innovation in the field of business, recognising the realities of modern day financial needs, encompassing not only working capital for production-based ventures but also allowing the growing service industry to benefit from Islamic modes of financing.⁷⁹⁴

⁷⁹¹ Usmani (n 691) 24

⁷⁹² Usmani (n 691) 42

⁷⁹³ C R.Nethercott and D M.Eisenberg, *Islamic Finance: Law And Practice* (Oxford University Press, USA 2012) 178

⁷⁹⁴ Meezan Banks Guide (n 719)

- v. ***Sharikat al-Wujooh***: a ‘reputational partnership’ wherein the partners have no investment at all. All that they do is purchase the commodities on a deferred price and then sell them at spot. The profit so earned is distributed between them at an agreed ratio.⁷⁹⁵

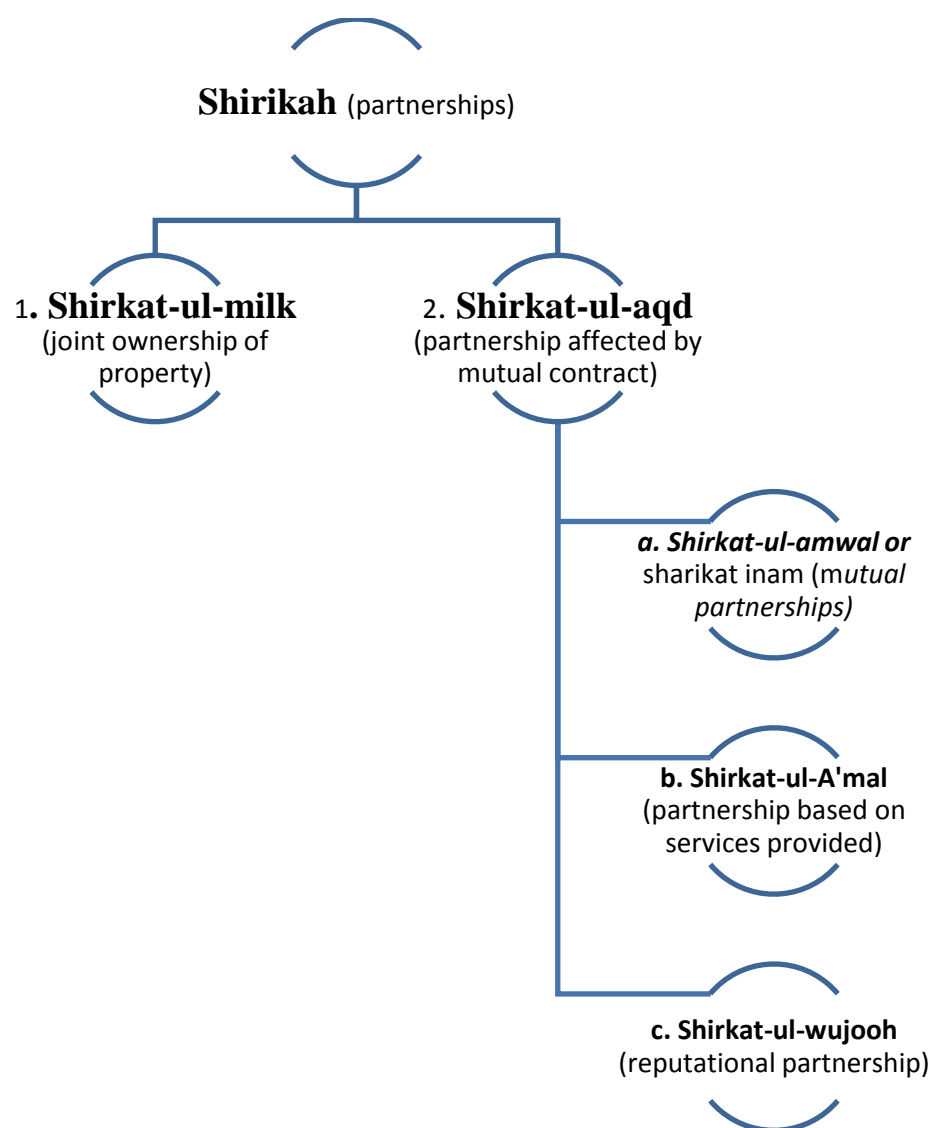


FIGURE 4 TYPES OF SHIRKAHS

Based on the different types of *Shirkahs* (partnerships) discussed, the term *musharakah*, which is itself not found in the books of *fiqh*, is a term coined by modern Islamic finance practitioners for their findings on the principles of *sharia*

⁷⁹⁵ Usmani (n 691) 23

relating to *Shirkah*.⁷⁹⁶ Specifically, the modern concept of *musharakah* as practiced by IFIs really encompasses only one particular kind of *Shirkah*, the *Shirkat-ul-amwal*, where two partners invest capital in a joint venture.⁷⁹⁷ However, there are instances of the *musharakah* being used as generic term for *Shirkat-ul-A'mal* (the partnership form for providing services). There is also a possibility for the partners to appoint a manager for the whole partnership who is allowed to be reimbursed by the partners. Nevertheless, this arrangement with the manager makes this *musharakah* look more like *mudarabah* and hence conceptually requires clarifications at times.⁷⁹⁸

7. The basic rules for concluding a valid *Musharakah*

Musharakah or *Shirkat-ul-amwal* is a financial instrument which has its roots in the law of contract. It is regulated by *sharia* and thus must comply with the basic tenets of a valid *sharia* contract. This includes, *inter alia*, being devoid of any kind of *gharar* (speculation) and *riba* (usury/interest based transactions), the presence of an existing subject matter, mutual consent,⁷⁹⁹ and issues relating to the ability of the parties to enter into a valid contract. These are embodied by the rules regulating all contracts under *sharia*.⁸⁰⁰ However, since the modern day *musharakah* is a specialised form of contract, there are some unique features that govern it over and above the basic contractual rules.⁸⁰¹ The *musharakah* can be entered into by simple agreement and need not be formalised in writing, although it is preferred that a

⁷⁹⁶ Usmani (n 691)

⁷⁹⁷ M N Siddiqi, *Partnership And Profit-Sharing In Islamic Law* (Published By The Islamic Foundation 1985)

⁷⁹⁸ Usmani (n 691) 43

⁷⁹⁹ M Noor 'Principles Of Islamic Contract Law'(1988) *Journal Of Law And Religion* Vol. 6, No. 1, 115-130

⁸⁰⁰ Y Musa 'Liberty Of The Individual In Contracts And Conditions According To Islamic Law.' (1955), *Arab Law Quarterly* V

⁸⁰¹ M.H.Kamali, *Islamic Commercial Law: An Analysis Of Futures And Options* (Islamic Texts Society, Cambridge, UK 2000)

written record be kept so as to minimise the chance of confusion.⁸⁰² The constituents of the *musharakah* give rise to an agency relationship between the contributing partners, where every partner is the agent of the other and every partner benefits from the partnership equally, unless the contract's terms and conditions specifically lay out a designated ratio for the division of profits.⁸⁰³

The other legal consequence of having an agency relationship amongst the partners is that it renders all the partners capable of participating in the running of the business,⁸⁰⁴ unlike *mudarabah* contracts wherein the *mudarib* has the authority to run the business and the *Rab-ul-Mal* can only interfere in the business venture when the *mudarib* allows him to.⁸⁰⁵ There is, however, a provision which allows the *musharakah* to be run akin to a *mudarabah* contract; if the partners agree upon a term in their contractual agreement that only one of the partners shall be managing the *musharakah* to the exclusion of all others, then that partner shall do so.⁸⁰⁶ This would naturally lead to the proviso that the non-active partner should be entitled to the profit only to the extent of his investment and the ratio of the profit allocated to him should not exceed the ratio of his investment, whereas the partner carrying out the management may be entitled to more on the basis of his contribution to the management of the business venture.⁸⁰⁷

In relation to the type of investments allowed in a *musharakah*, the traditional scholars from various schools of thought are almost unanimous in stating that a contribution in a *musharakah* has to be made in liquid form and not in the form of

⁸⁰² Meezan Bank Guide (n 719)

⁸⁰³ Siddiqi (n 777)

⁸⁰⁴ M.E.Hamid 'Islamic Law of Contract or Contracts' (2007) Journal Of Islamic And Comparative Law. 3:1-11

⁸⁰⁵ Iqbal And Mirakhor (n 692) 92

⁸⁰⁶ Siddiqi (n 777) 19

⁸⁰⁷ Meezan Guide (n 719)

commodities, kind or good will.⁸⁰⁸ This is primarily so because of the ratios of profit and loss to be determined at the outset of the agreement. The argument follows that if one of the partners contributes in liquid capital and the other contributes in commodity or some other fixed asset like a building, the division of the accruing profits or loss may not be easily discernible and may lead to an unjust distribution.⁸⁰⁹ However, there is a contemporary argument that this should no longer be a problem with the ability of the parties to get their commodities and fixed assets evaluated beforehand and to then determine the ratio of the profits and loss accordingly.⁸¹⁰

8. Distribution of profits under *musharakah*

The most important aspect of the *musharakah* from a legal, operational and governance point of view is the division of profits and it is here that the schools of thought under *fiqh* (jurisprudence) differ most drastically. The one overarching principle in *fiqh* regarding the *musharakah* is that the proportion of profits to be distributed between the partners must be agreed upon at the time of putting the contract into effect.⁸¹¹ The legal standing of a contract where this condition is not met is to consider the contract invalid.⁸¹²

The ratio of the profit for each of the partners must be determined in proportion to the actual profits accrued to the business, and not in proportion to the capital invested by him. The contract is not allowed to fix a lump sum amount for any one of the partners, or any rate of profit tied up with his investment.⁸¹³ This may seem unjust from a conventional contract law point of view, but the reason for such a

⁸⁰⁸ Usmani (n 691) 46

⁸⁰⁹ H Hassan 'Contracts Of Islamic Law: The Principles Of Commutative Justice And Liberality'(2002) Journal Of Islamic Studies

⁸¹⁰ Siddiqi (n 777) 28

⁸¹¹ Musa (n 780)

⁸¹² Diwany (n 711) 158

⁸¹³ Siddiqi (n 777) 22

provision is to ensure that no one partner may dominate the profit and loss ratio because of his relative bargaining power. Thus, this provision also falls in line with the aim of ensuring a just and equitable distribution of risks and returns.

However, to mitigate the possible harshness of the aforementioned rule, there is a provision under the *sharia* rules whereby a *musharakah* agreement may expressly provide for a term in the initial agreement agreeing a lump sum or a percentage beforehand for any one partner.⁸¹⁴ Nevertheless, this term in the contract will be subject to final settlement at the end of the specific time period. This means that if the *musharakah* has been successful and profits have accrued, then the fixed amount which had been promised and stated in the contract may be paid, but if there have been no profits the partner will have to return the amount. It follows that any amount which might have been drawn on by a partner shall be treated as an ‘on account payment’ and will be adjusted to the actual profit he deserves at the end of the term.⁸¹⁵

In the case of loss accruing to the *musharakah*, the juristic differences disappear and scholars unanimously agree that the loss that accrues has to be divided according to the capital contribution.⁸¹⁶ Further, whilst both the *Maliki* and *Shafi* scholars are of the view that both profits and losses are to be distributed equally, the *Hanbali* and *Hanafi* scholars allow freedom of contract when deciding profits but decline the freedom of the parties when deciding the loss.⁸¹⁷ The underlying principle here is distributive justice, so that whilst profit may be varied, the burden of loss can never be more than the initial contribution; embodying the core of profit and loss risk

⁸¹⁴ Usmani (n 691)

⁸¹⁵ Usmani (n 691) 25

⁸¹⁶ Iqbal and Mirakhor (n 692) 92

⁸¹⁷ Diwany (n 711)

sharing principles.⁸¹⁸ So in summary, profit is based on the agreement of the parties, but loss is always subject to the ratio of investment.⁸¹⁹

9. Termination of *musharakah* and related governance issues

Under the Sharia rules relating to *musharakah*, termination is permitted in three circumstances. The first circumstance is where every partner has a right to terminate the *musharakah* at any time after giving his partner(s) a notice to this effect. Upon doing so, the *musharakah* will simply come to an end.⁸²⁰ In this case, if the assets of the *musharakah* are in cash form, all of them will be distributed pro rata between the partners. If the assets are not liquidated, the partners may agree either on the liquidation of the assets, or on the distribution or partition between the partners of the assets as they are.⁸²¹ If there is a dispute between the partners in this matter; for example, one partner seeks liquidation while the other wants the partition or distribution of the non-liquid assets themselves, the latter shall be preferred. This is because after the termination all assets are jointly owned by the partners and as a co-owner, the distribution-seeking partner cannot be compelled to liquidate, owing to his right to seek partition or separation.⁸²² However, if the assets are such that they cannot be separated or partitioned (such as machinery) then they shall be sold and the sale proceeds shall be distributed.⁸²³

The second instance is where any one of the partners dies during the *musharakah*'s operation; the contract with him is terminated.⁸²⁴ His heirs will have the option

⁸¹⁸ Siddiqui (n 777)

⁸¹⁹ Siddiqui (n 777) 34

⁸²⁰ Siddiqui (n 777) 40

⁸²¹ Usmani (n 691) 44

⁸²² Sattar (n 707) 69-76

⁸²³ Usmani (n 691) 48

⁸²⁴ Siddiqui (n 777)

either to draw the share of the deceased from the business, or to continue with the contract.

The third instance is that if any one of the partners becomes insane or otherwise incapable of effecting commercial transactions, the *musharakah* is terminated.⁸²⁵

10. Termination of *musharakah* without closing the business

Different rules apply to termination if one of the partners wants to bring the *musharakah* to an end, but the other partner(s) would like to continue with the business; such a termination can be achieved by mutual agreement.⁸²⁶ The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of the *musharakah* with just one partner does not imply its termination between the other partners as well.⁸²⁷ The price of the share of the leaving partner must be determined by mutual consent and if there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the exiting partner can compel the other partners to liquidate or distribute the assets themselves.⁸²⁸

The question then arises whether the partners can agree, while entering into the contract of the *musharakah*, on a condition that the liquidation or separation of the business shall not be effected unless all the partners, or the majority of them, wants to do so and that a single partner who wants to leave the partnership shall have to sell his share to the other partners and not force them on liquidation or separation.⁸²⁹

It is argued that if such a term can indeed be allowed, this would then mean that as modern commercial agreements, *musharakah* contracts can be used without the fear

⁸²⁵ Usmani (n 691) 49

⁸²⁶ Usmani (n 706) 13-20

⁸²⁷ Muslehudin (n 732) 100

⁸²⁸ Meezan Banks Guide (n 719) 142

⁸²⁹ Usmani (n 691)

of unnecessary liquidation by an aggrieved partner, and would mean more certainty for Islamic finance partnerships and joint venture contracts. However, since there seems to be no known precedent for such an agreement, the *fiqh* scholars need to devise rules regarding this particular aspect to make it easier for the Islamic finance industry to compete at an international level.

Like the *mudarabah* contract, the *musharakah* method of financial intermediation also has some *sharia* and other legal issues, albeit on a smaller scale than *mudarabah* or *murabahah* contracts. The major reason for this is that *musharakah* contracts are actually the only genuinely *sharia*-compliant contract because they are pure partnerships with simpler rules for the division of labour and capital, thereby having simpler terms for the sharing of profit and loss.⁸³⁰ There is, however, some scepticism surrounding the use of *musharakah* contracts due to the fact that they may leave the capital contributors open to risks of moral hazards and adverse selections or may be deemed too simplistic in form to be effectively utilised as modern day financial intermediation contracts.⁸³¹

11. Sale-based contracts

The next category of Islamic financial instruments emanates from the basic sale contract and forms one of the largest types of basic *sharia*-compliant financial instruments that allow IFIs to compete at a global scale against other conventional financial institutions.⁸³² These sale-based contracts are also important because they epitomise the flexibility and innovation of the modern day IFIs as an industry and have shown the ability of Islamic finance as a system to adapt and mould itself with the changing times whilst still maintaining *sharia* compliance. Of the sale-based

⁸³⁰ Diwany (n 711)

⁸³¹ Vogel and Hayes (n 17) 239

⁸³² Iqbal and Molyneux (n 688)

contracts available, the most innovative and frequently used Islamic financial instrument is the *murabahah*.⁸³³ The other slightly less important sale-based contracts are *bay al salam* and *bay al muajjal* and then there are other contracts of exchange such as the *ijarah* and *istisna*.

Under Islamic law, the sale contract (called the *bai*) can be simply defined as ‘the exchange of a thing of value by another thing of value with mutual consent’.⁸³⁴ A sale contract under the *sharia* is considered valid if the following conditions are fulfilled: there has to be a written contract,⁸³⁵ the subject matter must be present, the price is determined and the subject matter must be in the possession of the seller or is capable of being delivered.⁸³⁶

According to El Gamal, in Islamic economics and law ‘sale is the ultimate permissible contract’ and can be defined as an ‘exchange of owned properties, including services and some property rights’⁸³⁷ and thus justified by the Qu’ranic verse itself which states ‘Allah has permitted trade and forbidden *riba*’.⁸³⁸ Hashim Kamali has gone on to define a sale from an Islamic commercial law perspective when stating that ‘[s]ale is by definition, the exchange of values between two parties by mutual consent.’⁸³⁹

When considering the aforementioned definitions, it can be seen that the sale contract under Islamic law encompasses a number of possibilities when deriving a financial instrument based on a sale, ranging from the basic sale contract with barter exchange to a complex sale contract like the *murabahah* and *istisna* which require

⁸³³ M T Yousef, *The Murabaha Syndrome In Islamic Finance: Laws, Institutions And Politics* In R. Wilson, *The Politics Of Islamic Finance* (Edinburgh University Press, Edinburgh 2004) 63-80

⁸³⁴ Meezan Bank Guide (n 719) 73

⁸³⁵ Mohammed (n 779)

⁸³⁶ Diwany (n 711)

⁸³⁷ M El Gamal, *Islamic Finance, Law, Economics and Practice* (Cambridge University Press, 2006) 65-66

⁸³⁸ As Quoted *ibid* El Gamal

⁸³⁹ Kamali (n 781) 95

multiple contracts being concluded simultaneously involving principles of agency, future price determination and exchange of ownerships.⁸⁴⁰ According to Iqbal and Mirakhor, the basic contracts under *sharia* can be divided into ‘contracts of exchange, sale of an asset or sale of rights to utilise an asset.’⁸⁴¹ They then further divide according to the type of sale, the first contract is the ‘sale of ownership’, whereas the second contract is the ‘sale of right to use’.⁸⁴² This particular division shows the depth of Islamic contract law and gives an insight into how Islamic law relating to contracts gives both practitioners and academics a chance to be more creative and innovative when designing financial instruments. A sale contract under Islamic law requires offer, acceptance and a meeting of minds for the buyer and the seller, and also has a number of restrictive injunctions imposed to ensure it is not subject to a *riba* (excessive interest) transaction and is devoid of any *gharar* (uncertainty).⁸⁴³

The sheer number of sale-based contracts utilised by IFIs makes it difficult to discuss all sale-based contracts, so only the most frequently used contracts in this category will be discussed; namely the *bai al-murabahah*, which epitomises the flexibility and innovation of the modern day IFI’s ability to adapt traditional *sharia* principles into modern day financial instruments. In addition, this contract shows the kind of regulatory and governance issues that come to the fore because of over-reliance on flexibility and innovation coupled with moving away from traditional sources of *sharia*.

12. *Murabahah* as a sale contract: *bay al murabaha*

⁸⁴⁰ Lewis and Algaud (n 722)

⁸⁴¹ Iqbal and Mirakhor (n 692) 80-81

⁸⁴² Iqbal and Mirakhor (n 692) 80-81

⁸⁴³ Mohammed (n 779)

The *murabahah* contract is one of the most frequently used financial instruments in the modern day Islamic finance industry. The concept has pre-Islamic origins and is considered, from a more conventional point of view, to be a fiduciary contract.⁸⁴⁴ *Murabahah* sales may be defined as selling goods under certain conditions; namely for a fixed percentage of the price or cost of the goods, or for a fixed amount of the money as profit. Professor Amin has translated the term *murabahah* as having two possible meanings: the first is ‘cost plus sale’ and the second is ‘fixed profit sale’.⁸⁴⁵ The first meaning has been used more frequently and will thus be used here too. The proper terminology for the *murabahah* contract is *bay murabahah*, which simply means that it is a sale contract. ‘*Bay*’ is Arabic for sale, whilst *murabahah* is derived from the Arabic word *riba* which means ‘gain or profit’, hence the effect of the words together as a phrase become ‘a sale for a fixed profit’.⁸⁴⁶ According to Tarek Al Diwany, ‘*bay al murabahah* is a trust sale, where the seller names the profit markup that he is applying to the cost price of goods that he is selling and agrees a sale price with the buyer on that basis.’⁸⁴⁷ It can be seen that in practice, buyers may make use of this sort of exchange contract when they lack experience in buying goods, merchandise, or any sort of property and want the IFI to both finance the commodity as well as hire an expert commercial agent (or let the IFI act as the agent) to purchase it. They find this way of dealing easier and more convenient, simultaneously avoiding the liability of bargaining with the sellers and examining the goods in a way they may not be skilled enough to deal with personally.⁸⁴⁸ The sellers, on the other hand, use this transaction because it guarantees a fixed

⁸⁴⁴ Nethercot and Eisenberg (n 773) 192

⁸⁴⁵ S H Amin, *Islamic, Banking and Finance* (Royston Publishers Illustrated Edition 1986)

⁸⁴⁶ Nethercott and Eisenberg (n 773) 193

⁸⁴⁷ Diwany (n 711) 130

⁸⁴⁸ M T Yousef, *The Murabaha Syndrome In Islamic Finance: Laws, Institutions And Politics* in R. Wilson *The Politics Of Islamic Finance* (Edinburgh University Press, Edinburgh 1997) 63-80

percentage related to the price or cost of the goods, to be gained as profit for the service provided in the form of an executed sale on behalf of the actual buyer.⁸⁴⁹

In modern Islamic banking practices, the *murabahah* sale is used to help a customer buy an asset that he may not otherwise be able to buy, by allowing the bank to first buy that particular asset upon the request of a particular client. The bank then sells that asset to the customer at an agreed and disclosed mark-up either for a lump sum amount or on instalments.⁸⁵⁰ By allowing customers to purchase goods in instalments, the Islamic finance industry has devised a method by which they can compete with the conventional leases and mortgages being utilised by conventional financial institutions. This contract of sale is further affected by the banks getting the customer to sign an undertaking whereby the customer promises to buy the property once the bank has bought it at its own risk. This way, when the bank or IFI buys the goods, there is a level of certainty that the customer will purchase it at a pre-agreed mark-up and thus mitigating the risk of the bank.⁸⁵¹

There are some issues with the use of *murabahah*, however. For example, the enforceability of the promise by the customer is not clear under *sharia* rules. According to *sharia* principles, simple promises do not have the same contractual enforceability under Islamic law as they do under common law or civil law legal systems.⁸⁵² Further, the promise is for a sale at a future date and may give rise to both *riba* (interest-based transactions) and *gharar* (uncertainty) since both the counter values are deferred.⁸⁵³ As we have seen in the discussion of *riba* and *gharar*, these are provisions against which *sharia* has been very clear.⁸⁵⁴ Nonetheless, it can

⁸⁴⁹ Abdullah and Keon Chee (n 702) 153

⁸⁵⁰ Usmani (n 691)

⁸⁵¹ Iqbal and Mirakhor (n 692) (This Will Be Discussed In Detail In The Next Chapter)

⁸⁵² Diwany (n 711) 135

⁸⁵³ Nethercott and Eisenberg (n 773) 195

⁸⁵⁴ Please for more detailed sources, refer to chapter 4 of this thesis regarding Riba and Gharar

be said that since the IFI is taking a risk in purchasing the goods without any certainty about their eventual disposal, the bank is justified in charging the mark-up profit on the basis of the risk and return equation emphasised by the basic business ethical norms (*Maqasid*) of *sharia* regarding profit and loss sharing.⁸⁵⁵

Furthermore, modern IFIs tend to get around this problem of risk allocation in a *murabahah* by signing a “master *murabahah* agreement” with the customer, which specifies the terms and conditions that both the parties have agreed upon including the actual price, the mark-up payable to the IFI and the date and schedule of delivery.⁸⁵⁶ All such terms and conditions have to be specific and decided upon prior to the enforcement of the contract otherwise the agreement will be considered void by reason of excessive *gharar* (uncertainty).⁸⁵⁷ The most important terms in such a contract are those relating to the price (disclosed actual price as well as the seller’s profit mark-up on the base price), transfer of title of the goods being sold (specifically, the seller must have obtained title over the goods before being able to sell them) and the method of payment (either a lump sum or deferred in instalments).⁸⁵⁸

The legal mechanism employed when an IFI brokers such a deal allows the bank to act as an agent for the customer; purchasing the good on behalf of the customer and then allowing that customer to enter into a contract with the actual seller. If the original seller allows for the customer to pay the price in instalments, the IFI is eligible for a commission or agency fee. Conversely, if the original customer is not willing to sell it at a deferred rate via instalments then the IFI, as the agent of the customer, buys the goods and pays a lump sum to the original seller and then gathers

⁸⁵⁵ Refer to chapter 2 of this thesis for the ideological background for this particular principle.

⁸⁵⁶ Abdullah And Keon Chee (n 702) 153

⁸⁵⁷ Usmani (n 691)

⁸⁵⁸ Nethercott and Eisenberg (n 773) 195-198

the rest of the decided price plus its own mark-up or agency fee. This is done in accordance with an agreement which may take the form of instalments or a lump sum payment. The result of this is that a credit facility can be in place for the customer without the interest payments.⁸⁵⁹

The other possibility is for the IFI to appoint the customer as the agent of the IFI and allow them to buy the goods required on behalf of the bank and then place them under the control and possession (actual or constructive) of the IFI. The IFI then sells the goods on credit to the customer in line with the agreed terms and conditions of the master *murabahah* agreement, which will specify the delivery and payment schedule.⁸⁶⁰

The flexibility and utility of *murabahah* in modern day IFIs can be seen from the fact that it is utilised as a mode of finance for the purchasing of assets, commodities and goods and can replicate credit sales without breaching the *sharia* principles (*Maqasid*) per se.⁸⁶¹ A mixture of *mudarabah* and *murabahah* contracts are also used for syndicate financing, thus allowing IFIs to compete globally for large development projects.⁸⁶² The developments in *murabahah* financing have been possible due to the extensive work done by the accounting standard setting body for IFIs (namely, the Accounting and Auditing Organisation for Islamic Financial Institutions or AAOIFI).⁸⁶³

The *murabahah* form of contract, despite being utilised in most IFIs, is probably the most controversial contractual form being employed by the modern day IFI, and has come scrutiny because it breaches certain main principles of *sharia*-based finance.

⁸⁵⁹ El Gamal (n 817) 66

⁸⁶⁰ Diwany (n 711) 132

⁸⁶¹ Abdullah and Keon Chee (n 702) 153

⁸⁶² Nethercott and Eisenberg (n 773) 193-194

⁸⁶³ <http://www.aaofii.com/>. For The Murabahah Standards, Please Refer To AAOIFI(Sharia Standard No 8 {Murabahah To Purchase Order}) 4/5

These criticisms will be discussed in more detail in the next chapter which discusses specific regulatory and corporate governance issues pervasive in IFIs utilising *murabahah* contracts.

13. Investment Account Holders (IAHs)

Another unique feature of the modern day IFI is the presence of a category of account holders called ‘investment account holders’ who are a sort of a hybrid account holder in that they have certain characteristics of both investors and account holders.⁸⁶⁴ These are the account holders who enter into a *mudarabah* contract with the bank wherein the bank invests the capital/investment of the account holder as a *mudarib* (agent) of the account holder (the *Rab-ul-Mal*/investor) and therefore guarantees no fixed return (since it is an investment according to a *mudarabah* contract and liable to only a proportion of profits, if there are any). This category of account holder creates a number of governance and regulatory issues arising from the fact that IAHs are both investors (akin to shareholders) and depositors (akin to their conventional counterparts). However, they lack the control (via the ability to vote in the AGM) that traditional shareholders would have in the running of a corporation, as well as lacking the security of a traditional depositor in terms of a fixed return or interest on initial investments (for example, deposit insurance, which because of its fixed nature of returns is not permitted under *sharia*).⁸⁶⁵ Thus, IAHs are a class of stakeholder in the governance framework of IFIs which require special recognition and protection from both a *sharia* and conventional regulatory point of view.⁸⁶⁶ These issues will also be discussed in the following chapters.

⁸⁶⁴ Errico and Farhbaksh ‘Islamic Banking: Issues In Prudential Regulation And Supervision’(1998) IMF Money and Exchange Department, Wp/98/30, Working Paper

⁸⁶⁵ ibid Errico and Farhbaksh

⁸⁶⁶ Iqbal and Mirakhor (n 495) 43-63

14. Conclusion

This chapter has examined only the three basic modes of Islamic finance that are utilised by the modern day IFI. Notwithstanding, there are many other important financial instruments used by modern IFIs such as *ijarah* (a lease) and *istisna* (the sale of future assets, which is allowed as a strict exception to the rules of Islamic finance prohibiting buying and selling goods that do not yet exist in order to finance a construction project).⁸⁶⁷ The recently introduced *sukuk* (Islamic bonds) are also noteworthy, but are not within the scope of this text.⁸⁶⁸ This refined focus notwithstanding, the purpose of discussing the intermediary contracts of *mudarabah*, *musharakah* and *murabahah* – in addition to the distinct IFI feature of the SSB and IAHs – was to highlight the kind of *sharia* compliance and governance issues that may arise when designing a regulatory framework for the Islamic financial industry as a whole. Such a system also has to take into account micro prudential issues, such as the ones highlighted in the application of traditional *sharia* rules to modern day IFI practices in the context of specific financial instruments. In addition, it should strive to focus on more contemporary corporate governance issues that may arise due to IFIs functioning as legal entities incorporated with limited liability that have to comply with the legal rules of the jurisdiction where they are incorporated whilst also being *sharia*-compliant. As a result, it can be said that governance and regulatory issues surround the SSB and IAHs. These corporate governance issues will be discussed in the next chapter(s) in detail.

⁸⁶⁷ Iqbal and Mirakhor (n 692)

⁸⁶⁸ Diawany (n 711)

CHAPTER 7: SPECIFIC CORPORATE GOVERNANCE ISSUES FOR IFIs

1 Introduction

As we saw in the previous chapter, modern IFIs – like any other corporations - need to have a carefully devised corporate governance framework in place to prevent any failures that may occur because of internal or external issues. Despite the fact that there is a push from academics and practitioners alike to move towards a more stakeholder-oriented framework, the dominant form of corporate governance for the last three decades has remained the neoliberal shareholder-oriented approach because of a wave of deregulation in the 1970s and the 1980s in the USA and the UK, which have shaped the face of modern corporate governance theory and practice.⁸⁶⁹

Having established in the previous chapters that the shareholder-oriented approach is unsuitable for IFIs based on both contemporary and traditional literature, we will now establish how in practice the influence of the neoliberal ethos has opened the Islamic finance industry to systemic risks at the micro- and macro-level. It will reinforce the claim that the stakeholder theory is well-suited to IFIs, by providing suggestions as to how such an approach can be used to solve most of the corporate governance issues arising in IFIs.

2. The stakeholder view and Islam

As we have already established, the stakeholder view is of the utmost ideological as well as practical importance when implementing corporate governance in Islamic

⁸⁶⁹ Z Iqbal and A Mirakhor, 'Stakeholders Model Of Governance In Islamic Economic System,' (2003) In The Fifth International Conference On Islamic Economics And Finance: Sustainable Development And Islamic Finance In Muslim Countries, IRTI, Islamic Development Bank Bahrain

financial institutions.⁸⁷⁰ Stakeholders' values are generally incorporated in the mission statements of such institutions.⁸⁷¹ A review of these mission statements, coupled with the Islamic economic model described in the previous chapter, emphasises that corporate governance in IFIs should focus on two broad objectives from a stakeholder point of view: compliance with *sharia* principles (*Maqasid al sharia*) and the provision of high quality services to all stakeholders (including customers, investors and other stakeholders).

As defined above, compliance with *sharia* would then translate into the following aims for the Islamic finance industry: interest-free business, the furthering of socioeconomic justice, and development and promotion of the Islamic financial system. According to Iqbal and Mirakhor,⁸⁷² high quality services in the context of IFIs would mean providing services to the community as a whole (referring primarily, but not exclusively to the Muslim community); promoting the interests of related parties including shareholders, depositors and employees, and the development of professional and ethical qualities of management and staff.

3. Issues in implementing stakeholders' views in Islamic financial institutions

The Governor of the Bahrain Monetary Agency conveyed the nature of IFIs' roots in stating that 'Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles.'⁸⁷³ This statement outlines the fundamental aims and objectives

⁸⁷⁰ Zamir and Mirakhor (n 495)

⁸⁷¹ Wafik, Grais, and P Mattio 'Corporate Governance And Stakeholders Financial Interests In Institutions Offering Islamic Financial Services' Stockholm: World Bank, November 2006

⁸⁷² Iqbal, Zamir and A Mirakhor (n 495) 43-63

⁸⁷³ Bahrain Monetary Agency. *Islamic Banking And Finance In The Kingdom Of Bahrain* (Bahrain Monetary Agency, Bahrain, 2002)

of the Islamic finance industry in the context of how it is generally viewed, and goes on to explain what a stakeholder point of view would eventually mean for IFIs.

This pledge to conduct activities in accordance with *sharia* principles entails that IFIs would not: engage in interest-based transactions, conduct a purely financial transaction disconnected from real economic activity, engage in any transaction where there is exploitation of any party; participate in any activity or transaction that is harmful to society or participate in any activity that is not *sharia* compliant.⁸⁷⁴ This lays out a specific outline of what stakeholder activities would entail for IFIs in both a conventional stakeholder context as well as a *sharia*-based stakeholder point of view.

Failure to ensure compliance with these basic principles of corporate governance by IFIs would defeat the purpose of the Islamic finance industry and would lead to systemic risks; the most dangerous of which would be reputational risk, that would also encompass *sharia* noncompliance and *sharia* governance risks.⁸⁷⁵ To mitigate such risks, corporate governance structures need to be created to assure the stakeholders that all transactions and activities are *sharia* compliant, incorporating *sharia* compliance into the corporate governance framework for IFIs. However, the unique nature of IFIs raises other corporate governance issues that may not be present in conventional financial institutions and need special consideration. Examples of such issues include the presence of the SSB, the different account holders and their legal standing, the issue of informational asymmetry and issues surrounding transparency and disclosure requirements.⁸⁷⁶

⁸⁷⁴ E B Satkunasegaran 'Corporate Governance and The Protection Of Customers Of Islamic Banks,' In International Islamic Banking Conference (2003) Prato, Italy

⁸⁷⁵ S Archer and R Ahmed Abdel Karim, *Islamic Finance The Regulatory Challenge* (Wiley Publishers 2007)

⁸⁷⁶ Grais and Pellegrini (n 850)

Given that the fundamental aim of the Islamic financial institution is to enable its stakeholders to pursue their financial interests as well as fulfilling their religious and ethical duties, the corporate governance arrangements for IFIs need to take into account the importance of having a framework that credibly protects these interests whilst not breaching the values that underpin the ideology of Islamic finance. It is thus argued that for an effective corporate governance framework for IFIs, attention should be focused primarily on three categories of stakeholders, namely: shareholders, depositors, and borrowers.⁸⁷⁷

Academics are of the view that the basic incompatibility of the neoliberal shareholder primacy model with the Islamic finance model stems from two major issues:⁸⁷⁸ firstly, the recognition of property rights in Islam as belonging to the individual as well as society and secondly, the issue of contractual enforcement under Islamic law being different in the sense that under Islamic law, whilst there is freedom of contract under Islamic law, that freedom is constricted by the specific terms and conditions as enumerated by the basic principles of *sharia*(*Maqasid*) which focus primarily on the overarching principle of the protection of weak and exploitable parties to the contract.⁸⁷⁹

The stakeholder approach, as we have already examined, fits within the framework of Islamic ethics and finance, since the stakeholder theory accepts the rights of ‘other stakeholders’ besides the capital contributors (the shareholders in a

⁸⁷⁷ Islamic Banker. *Creating Best Practice In Shariah Advisory*, Issue No.78, July 2002

⁸⁷⁸ Academics here include; Taqi Usmani (2000), Iqbal and Mirakhor(2003) and (2007), Tarek al Diwany (2010), Vogel and Hayes (1998), M A Afzalur-rahman (1974), Ahmad (1994) and (2000), Al-'Alwani and El-Ansary (1999), F Al-omar and M Abdel-haq (1996), M U Chapra (1985) ,(1987), (1992) and (2000a &b), M U Chapra and T Khan (2000), M U Chapra and H Ahmed (2002), S Haron (1995), (1999) and (2000), Luca Errico and Mira Farhbaksh (1998), S N H Naqvi (1981) (2001) and (2003), M A A Sarker (1999), E B Satkunasegaran (2003), Simon Archer and R A Abdel Karim (2007), Wafik Graiss and Matleo Pellegrini (2006), R Wilson (1997)

⁸⁷⁹ R Wilson ‘Islamic Finance And Ethical Investment’ (1997) *International Journal Of Social Economics*. 24 (11), 1325-1342

corporation).⁸⁸⁰ Another reason for accepting the stakeholder theory as being in line with the basic principles of Islamic financial ethics is that it is a practical manifestation of the business ethics philosophy, which means that it is opposed to the self-justifying ends of pure profit making of corporations propounded by the shareholder primacy theory of corporate governance.⁸⁸¹ This is an ideological position which is also at the core of Islamic principles (the *Maqasid*) of business ethics as seen in chapter two.

The stakeholder approach is therefore suitable for IFIs in theory, but there remain questions over whether it can be upheld in practice. One of the major reasons for this is the intense competition in the international financial market that has forced IFIs to move away from their basic principles and accept certain practices which may not be *sharia*-compliant.⁸⁸² This has resulted in some unique corporate governance problems for IFIs, aggravated by certain characteristics of Islamic finance, such as: the presence of investment account holders (IAHs) and *sharia* supervisory boards (SSBs), issues surrounding the commingling of funds in banks utilising Islamic windows, the use of traditional Islamic contracts to duplicate conventional financial products, the ill-defined regulatory environment internationally and other similar issues.⁸⁸³ The lack of a coherent corporate governance theory specifically tailored for IFIs has added pressure for IFIs to comply with the existing corporate governance practices which have an undertone of a more shareholder-oriented profit maximising approach, resulting in specific risks that are faced by the IFI as part of the Islamic finance industry.

⁸⁸⁰ Satkunasegaran (n 853)

⁸⁸¹ Chapra and Ahmed (n 754)

⁸⁸² Iqbal and Molyneux (n 688)

⁸⁸³ Errico and Farhbaksh (n 590)

This chapter looks at some of the more prominent corporate governance issues that arise out of the workings of the IFIs and suggests some solutions to those problems, keeping in view the stakeholder theory and the basic ethical principles of Islamic ideology surrounding finance and commerce.

This chapter will be divided into two parts. The first part will deal with specific governance and regulatory issues arising from the use of the three basic *sharia*-compliant financial instruments and contracts as discussed in the previous chapter: *mubarakah*, *musharakah* and *murabaha*. The second part will look at more general corporate governance issues that arise from the operation of IFIs, such as concerns surrounding the SSB and their role from a corporate governance point of view, the protection and obligations of the IAHs which are not well-defined in the current legal and regulatory framework, and the operation of the two-tiered *mudarakabah* contracts. In the next chapter, we shall explore the repercussion of not having a uniform and well established regulatory and enforcement framework.

4. Specific governance issues in Islamic financial instruments: a case study of *mudarakabah*, *musharakah* and *murabaha*

As we have already seen, the basic financial intermediation in IFI is carried out on the basis of the two-tiered *mudarakabah* model of Islamic banking. In line with this, IFIs offer three types of accounts:⁸⁸⁴ current accounts, unrestricted investment accounts and restricted investment accounts.

⁸⁸⁴ Ahmad (n 697)

5. Investment account holders and the two-tiered *mudarabah*

Each category of accounts as practiced in modern day IFI's pose different issues for implementing corporate governance under the Islamic economic model but that of unrestricted investment account holders (UIAHs) are the most challenging. One problematic aspect is the ability of such account holders to have asymmetrical interest in risk and return of an IFI's costs and profits respectively.⁸⁸⁵ UIAHs are often the most important category of IFI depositors, since they enter into a *mudarabah* contract with the financial institution to manage their funds and the institution then places these funds in investment pools, and the profits on investments - if there are any - are distributed at maturity according to the profit and loss sharing (PLS) ratio specified in the contract.⁸⁸⁶ The UIAHs, and not the IFIs, bear the risk of a poor performance of the investment pool. Therefore, it is argued that the account holders must be given more rights and a more active supervisory/monitoring role over the working of the IFI. This is to ensure that the risk and return equation for the UIAHs is proportionate to the other equity providers (the shareholders) who, because of their legal standing in a corporation, are deemed to be legal (residual) owners of the corporate property and thus have greater control over the working of IFIs.⁸⁸⁷ The reason for this position is that modern corporate law and corporate governance are reflections of the neoliberal ethos, which holds shareholders as the true recipients of all legal rights including controlling rights accruing to the residual owners of the corporation and thereby discards other stakeholders as having any major role in the corporation. This position is clearly not suitable for IFIs, who need to adopt a stakeholder-oriented approach of governance

⁸⁸⁵ Abdullah and Chee (n 702)

⁸⁸⁶ Haron (n 761)

⁸⁸⁷ Al-Omar and Abdel-Haq (n 712)

so that the other stakeholders like the UIAHs who are as much contributors to equity as the shareholders are protected and catered for alongside the shareholders.⁸⁸⁸

6 The two-tiered *mudarabah* and disclosure requirements

The *mudarabah* contract which forms the backbone of the modern day Islamic finance has major issues which, if not addressed, may cause systemic corporate governance complications.⁸⁸⁹ The first issue is that the validity of this practice has been questioned by traditional scholars because of the form in which the *mudarabah* is being utilised in the two-tiered *mudarabah* model.⁸⁹⁰ Although there is agreement that the *mudarabah* was in fact practiced by the Prophet Muhammad himself, there are some serious questions as to the validity of the two-tiered model, on the ground that when the bank accepts deposits as a *mudarib* (agent) from the customers (as *Rab-ul-Mal* or the investors) does the bank/ IFI as a *mudarib* have the legal and *sharia* authority to forward the same money to another *mudarib*, this time as the *Rab-ul-Mal*? This is questionable because for the IFI to act as the *Rab-ul-Mal*, it would actually have to 'own' that capital, which in a two-tiered model they do not, as they are mere agents of the original *Rab-ul-Mal*.⁸⁹¹ According to Muhammad Anwar, quoting Khittab: '*fuqaha* (Muslim jurists) are in agreement that a *mudarib* is not entitled to forward *mudarabah* money to a third party for business'.⁸⁹² If this is indeed the case, the model of modern IFIs fails on ideological and legal basis - how can IFIs forward money under a *mudarabah* contract without actually owning that

⁸⁸⁸ Satkunasegaran (n 698)

⁸⁸⁹ Ghazi (n 693) 3-7

⁸⁹⁰ Archer and Abdel Karim (n 700)

⁸⁹¹ M T Usmani 'Shariah Governance Of Investment Funds,' (Winter 1996/1997), The American Journal Of Islamic Finance, Vol. VII, No. 1, 13-20

⁸⁹² M Anwar 'Islamicity Of Banking And Modes Of Islamic Banking' (2003) Arab Law Quarterly, Vol. 18, No. 1 (2003), 62-80 ,Brillstable URL: <http://www.jstor.org/stable/3382068> Accessed: 17/09/2010 08:22

money as they are supposed to under the *sharia* rules pertaining to ownership of funds? Despite this legal and ideological conundrum, it must be noted that the permission of such a transaction can be derived from an exception to the aforementioned opinion, which is that such a transaction can indeed be carried out with the permission of the original *Rab-ul-Mal*.⁸⁹³ Whilst the exception to this rule (allowing the IFI to use such capital with the permission of the original owner) in academic parlance justifies the use of the *mudarabah* as a valid *shariah*-compliant instrument to structure the modern IFIs operation, it raises a question about the ethics of such a practice. This is because the issue of calling the IFI the *Rab-ul-Mal* in the two-tiered *mudarabah* remains contentious; this ‘passing off’ of the IFI as the actual owners of the capital may amount to misrepresentation in legal terms, unless the IFI declares publicly and categorically to their customers and other stakeholders that they are not the actual owners of capital and are just acting as agents for other capital contributors (the original investors).

The question must then be: do all IFIs disclose to all of their investing customers (specifically UIAHs and IAHs) the possible risks and returns that their investments may be exposed to, and under what circumstances and conditions their investments are being forwarded to other investors. This raises serious corporate governance and ethical questions relating to the relationship between the IFIs and the customers and also between the IFIs and borrowers. This also raises major concerns for the transparency of the working of the IFIs.⁸⁹⁴ It is thus argued that to cater to this particular issue, the IFIs should institute measures that ensure disclosure of as much information as possible to all customers and investors in a transparent way, so the

⁸⁹³ Ibid Anwar 71

⁸⁹⁴ Archer and Abdel Karim (n 854)

customers are fully aware of the kind of risks that their deposits are going to be exposed to.⁸⁹⁵

7 Investment account holders and legal ownership issues

Another aspect which makes the issue of disclosure extremely important is that under the traditional *mudarabah* contract the unrestricted investment account holders (who actually contribute to the capital of the IFI just like conventional shareholders) remain the owners of the capital and the IFIs merely act as agents of the UIAHs rather than as owners of the capital. Compare this with a modern corporation, where those who buy shares in the company are owners of the shares and no longer the capital, which is now owned by the company. So on the one hand, the IFI is acting as the agent of the depositors and are thus holding the capital on trust for the IAHs. On the other, the shareholders of the IFI who have also contributed equity maintain control of the capital and the assets of the IFI via the board of directors (BOD) including the capital contributed by the UIAHs. This in turn creates an imbalance of power between the two equity contributors: the shareholders maintain control of the IFI and thus their investments via a default legal mechanism which translates into a reasonably robust monitoring process of participation and voting in the AGM (and other legal measures under company law),⁸⁹⁶ whereas the UIAHs relinquish control over their capital (despite maintaining ownership) and have no protection and no supervisory role because of the nature of their investment under *sharia* principles.⁸⁹⁷

⁸⁹⁵ Iqbal and Mirakhor (n 692)

⁸⁹⁶ Other measure may include, derivative actions, minority shareholder protection mechanism under most company law regimes, persuading the bod to vote in a particular way, in case of being an institutional shareholder having a board member etc.

⁸⁹⁷ Because under a traditional *mudarabah*, the *rab-ul-mal* (the capital contributor) cannot interfere with the working of the *mudarib* (the agent), unless the *rab-ul-mal* (the capital contributor) can prove

8 Investments account holders and deposit protection: a governance risk

The UIAHs face another dilemma in IFIs: despite being categorised as depositors, they are not protected under the conventional depositor insurance schemes because such a scheme would fall foul of the rules of *riba*.⁸⁹⁸ Thus, the UIAHs - despite being one of the main capital contributors to the IFI - have neither the control nor the supervision of their investments that traditional shareholders have, nor are they protected under deposit protection schemes as are conventional depositors, leaving them both vulnerable and powerless in corporate governance terms, raising serious concerns.

It is therefore contended that disclosure by IFIs to IAHs (including both the RIAHs and UIAHs) is paramount to allow them proper supervision of their investments. This disclosure of information by IFIs is important from a corporate governance point of view because otherwise, under a traditional *mudarabah* contract regulated under the *sharia*, IAHs (being the *Rab-ul-Mal*) are not allowed any supervision or interference in the working of the *mudarib* (the IFI in this case).⁸⁹⁹ This lack of safeguarding for IAHs as equity contributors is an issue of serious corporate governance concern, especially when compared to the other class of equity contributors in a normal corporation; the shareholders who have the ability to supervise their investments by voting in the BOD supposedly looking after the interest of the shareholder.⁹⁰⁰ Secondly, normal shareholders can sell their shares if

negligence. In essence this means that under normal circumstances the *rab-ul-mal* (the UIAH) can neither supervise nor control what the IFI does with the capital, thus eroding any control element that UIAH may have wanted to maintain over their own investment. This is less of a problem for the RIAH'S (the restricted investment account holders), since the depositors have already restricted the kind of investments activities they want the IFI to carry out with their capital, this then automatically then means that RIAH'S will have some control right from the outset of the contract.

⁸⁹⁸ Vogel and Hayes (n 17)

⁸⁹⁹ Chapter 5 Pg 11

⁹⁰⁰ Archer and Abdel Karim (n 854)

they are not happy with an aspect of the company's working. In a *mudarabah* contract, the *Rab-ul-Mal* can terminate the contract under the traditional *sharia* rules, but that becomes difficult when the IFIs stipulate a minimum time period for the *mudarabah* contract.⁹⁰¹ In essence, this means that for the duration of that contract, the *Rab-ul-Mal* cannot withdraw his capital, even if they are unhappy with the way the IFI is handling the investments. The only possibility that the *Rab-ul-Mal* (the UIAH) has to terminate the contract is to claim negligence on the part of the IFI as per traditional *sharia* rules, which in itself is fraught with procedural and legal difficulties.⁹⁰²

9 Investment account holders and negligence: the legal risk

Although alleging negligence is, as briefly described earlier, one method for IAHs to supervise and protect their investments, it raises both legal and ethical questions. One such problem is the difficulty of proving actual negligence in the absence of any specific judicial or *sharia* guidelines as to what amounts to negligence for this purpose. This particular aspect needs special attention from the judiciary as well as the main standard setting bodies, (the IFSB and the AAOIFI) otherwise there is a risk of frivolous claims of negligence by the IAHs in order to get out of a bad bargain. For the IFIs, this means an additional litigation risk and possibly increased agency costs (or extra reserves) to account for such instances.

10 Taking the board of directors on board: a possible solution?

One proposed solution for the issues discussed above is increased supervision by the board of directors on behalf of the account holders, providing similar protection to that afforded to shareholders. However, this raises the classical corporate

⁹⁰¹ Usmani (n 691)

⁹⁰² Iqbal and Mirakhor (n 692)

governance question of why the board would endeavour to protect the IAHs, since their main concern is the protection of shareholders under traditional corporate governance theory and practice(s). The board owes a legal duty to the shareholders as their ‘agents’, but no such duty is owed under traditional ideology to protect the interests of other stakeholders.⁹⁰³ Thus it is argued that the traditional en vogue Neo liberal corporate governance is ideologically incompatible with Islamic finance and its aims and principles (*Maqasid*).

11 A two-tiered board of directors for IFIs: The European corporate governance model

Another proposal to safeguard the interests of the stakeholder – especially IAHs – comes from the corporate governance model utilised in continental Europe. This involves a two-tiered board; with one tier consisting of executive directors elected by the shareholders and the other comprised of representatives of other stakeholder groups such as employees and creditors. This second tier would sit in a supervisory capacity in order to monitor and ensure that stakeholder interests are catered for.

A similar model can be introduced with amendments in IFIs across the Industry. The IFIs already have a second board in the shape of the SSB, but this board’s remit is limited to deciding religious aspects of the IFI’s affairs. However, by making certain alterations to the composition of this board, additional duties can be granted to this board to bring it in line with the continental European model. More members from other stakeholders can be introduced on the SSB (or the name of this new board can

⁹⁰³ This again is a contentious concept, since the corporate theory points to the fact that the BOD or the management is actually the agents for the company as a whole. However the reality is that because of the nature of the corporations combined with the fact that the ‘majority’ shareholder(s) are considered as the embodiment of company (for all practical purposes) as they have the right to elect any new directors, pass special resolutions to change the company’s constitution and need a simple majority to decide most of the matter relating to the day to day working of the company. It is thus argued that in essence the BOD is then deemed to be the agents of the shareholders.

be changed), thereby maintaining the role of religious supervision but adding other stakeholder representatives with monitoring and supervisory duties. These representatives would not be involved in the religious aspects of the IFI, but would ensure the interests of other stakeholders and maintain a purely supervisory role over the working of the IFI. This can be achieved by making certain amendments in the constitution (the Articles of Association) of the IFI and specifically laying down the exact duties and obligations of the other members of the SSB (or the stakeholder board).

It is argued that by making the necessary changes in the governance structure of Islamic financial institutions and involving a more expansive array of stakeholder groups in the decision-making process, the Islamic finance industry will be more in line with the stakeholder model of corporate governance as well as closer to ethical values (*Maqasid*) of Islamic finance and economics.

12 The investment account holders and the agency problem.

Since it has been established that the investment account holders are stakeholders akin to shareholders, therein lies another theoretical corporate governance issue. In essence, the IAHs are principals entrusting their resources to an agent - the financial institution's management – with the significant difference that, in their case, the agent is appointed by another principal; the shareholder.⁹⁰⁴ It is further argued that not only are the BOD elected by the shareholders, but the SSB is also selected and appointed by the BOD (and so also indirectly elected by the shareholders).

⁹⁰⁴ D El-Hawary, W Grais and Z Iqbal 'Regulating Islamic Financial Institutions: The Nature Of The Regulated' (March 2004) Policy Research Working Paper 3227, Washington, World Bank

This raises fears of a conflict of interests between the supervisory roles of the BOD as well as the SSB,⁹⁰⁵ since the argument is that to counter the IAH's inability to themselves monitor their interests under a conventional *mudarabah* contract, the SSB should be given the duty to do so. However, if they are appointed by the BOD, which then in turn is elected by the shareholders, the chances are that the classic agency problem would arise whereby the SSB are expected to look after the interests of another category of stakeholders to whom they owe no specific legal duties under the conventional shareholder-oriented corporate governance model.⁹⁰⁶ It is thus argued that the SSB should consist of additional members from the stakeholders (specifically from the IAHs and employees) so that the board may reflect the interests of the stakeholders and not only shareholders, therefore overcoming this classic agency conflict.

The second problem that arises in applying the *mudarabah* model to modern day Islamic finance is that under classical Islamic law, the *mudarabah* profits can only be distributed once the venture has been wound up and all its assets sold off.⁹⁰⁷ But when this classic model is applied to modern Islamic banking, the problem arises as to how to justify distributing profits annually, as is the practise in modern day IFIs, to keep the customers happy and well served with annual returns out of the profits (or in other words, the returns on investments for the depositors).⁹⁰⁸ Furthermore, how can the banks offer depositors different maturities or liquidity options and how can they apportion the exact amount of return that a particular depositor has earned? According to Vogel and Hayes, the solution has been given in the form of a new legal concept of a 'public' or 'shared' *mudarabah* attributed to Sami Hamoud. This

⁹⁰⁵ Iqbal and Mirakhor (n 692)

⁹⁰⁶ Nasser M. Suleiman 'Corporate Governance In Islamic Banks' See <http://www.Al-Bab.Com/Arab/Econ/Nsbanks.Htm>.

⁹⁰⁷ Usmani (n 691)

⁹⁰⁸ El Gamal (n 817)

type of *mudarabah* essentially continues unaffected by changes of membership and its returns are determined not by actual liquidation, but rather by using accounting techniques to provide a constructive or conjectural equivalent to liquidation.⁹⁰⁹

13 Profit equalisation reserves and investment risk reserves: the corporate governance issues

Another innovation to counter this hurdle is that of a reserve against loss so that the depositors agree in advance to donate a portion of their gains to a charitable fund to be used to meet losses of later investors or if unused to be given to charity.⁹¹⁰ These special reserves are called Profit Equalisation Reserves (PERs) and Investment Risk Reserves (IRRs). These reserves function in order for the IFIs to mitigate any losses that may occur to the UIAHs' investments. Consequently, the IFIs need to pool their reserves and profits to provide continuous profits to UIAH or in essence smooth profit returns to the IAHs.⁹¹¹ However, such pooling of resources may create conflicts of interest between shareholders and depositors because the management's decision to pool resources can result in preferential treatment to UIAHs.⁹¹² In turn, this may reduce the transparency of the IFI in terms of compliance with their depositors' investment objectives, raising a major corporate governance and ethical issue for the contemporary IFI.⁹¹³

The use of PER and IRR funds raises issues pertaining to the governance of these funds and the protection of UIAHs' rights. The 'smoothing out' of profits to UIAHs

⁹⁰⁹ Decision 5 fourth session(1988), Fiqh academy journal as quoted in Vogel and Hayes (n 17)

⁹¹⁰ Vogel and Hayes (n 17) 133

⁹¹¹ Chapra and Habid (n 754)

⁹¹² U Chapra and T Khan 'Regulation and Supervision Of Islamic Banks' (2000) Occasional Paper No. 3. Islamic Research And Training Institute: Islamic Development Bank, Jeddah

⁹¹³ M Bagsiraj, *Islamic Financial Institutions Of India: Their Nature, Problems And Prospects* in Iqbal, M. and D T Llewellyn (Eds.), *Islamic Banking And Finance: New Perspectives On Profit-Sharing And Risk* (Edward Elgar Publishing, Northampton, MA, USA, 2002

is an obvious obstacle to transparency and so is a major corporate governance issue.⁹¹⁴ By maintaining constant periodical profit distribution to unrestricted investment account holders, the management is giving the illusion that their organisation is performing healthier financially than may actually be the case.

An informal survey of 13 IFIs carried out by El-Hawary, Grais and Iqbal shows that of the 4 that admitted resorting to reserves, only 2 provided information in their financial statements and annual reports on the share of funds transferred from or to these reserves.⁹¹⁵ Thus, it can be asserted that such limited disclosure does not assure UIAHs of their fair treatment, and this may cause a number of account holders to leave the IFI, fearing lack of transparency. It is believed that the reason behind having these reserves is simply to avoid bank runs by IAHs, because of the volatility of the IAH's investment and the possibility of the loss, which further makes the issue of return over initial investment very contentious. This basically emanates from the nature of the *mudarabah* contract and the structure of IFIs being poised as a profit and loss sharing entity. In essence, since there can be no guaranteed return on investments made by IAHs, IFIs are at risk of losing their customer base if they were to declare losses on investments made by the IAHs (which they should be bound to do ethically and legally under *sharia* rules regarding finance). However, this does not happen because corporations are naturally cautious of deterring future investors by declaring losses.⁹¹⁶ It is observed that in practice, in order to avoid the situation where the IFIs may have to declare losses, they were forced to create the PER and the IRR to somewhat mitigate such a risk, maintaining their competitiveness in the international market. The conceptual clarity of these reserves and their compatibility

⁹¹⁴ A Bashir 'Risk And Profitability Measures In Islamic Banks: The Case Of Two Sudanese Banks' Islamic Economic Studies, 6(2), 1999

⁹¹⁵ D El-Hawary, W Grais And Z Iqbal, 'Regulating Islamic Financial Institutions: The Nature Of The Regulated' (March 2004) Policy Research Working Paper 3227, Washington, World Bank

⁹¹⁶ Archer and Kareem (n 854)

with *sharia* is a matter of debate as having such reserves to cover losses may fall foul of *riba* rules if they amount to a guaranteed return. This is likely to be so in such cases because *mudabarah* contracts operating under the PER and IRR are accompanied with the implicit assurance of returns. This also contravenes the concept of profit and risk sharing, since there is an assurance that there would never be any loss.⁹¹⁷ Thus from a traditional *sharia* compliance point of view, the use of PER and IRR amounts to a major corporate governance risk.

There is also an argument made by some contemporary academics and practitioners that PER and IRR can be deemed to emulate the interest-bearing accounts which are present in conventional banks.⁹¹⁸ The argument is that the pressure to declare dividends for shareholders and the pressure to declare profits annually for the IAHs has led the Islamic finance industry to be purely profit-oriented and move away from their basic ideology of risk and return, distributive justice, non-speculative trading and their normatively stakeholder-oriented approach. It is gradually bearing resemblance to conventional neoliberal shareholder-oriented corporations. Thus, there is a definite requirement for the Islamic finance industry to reorient itself and go back to its roots of an ethical, religious and stakeholder-oriented industry.

Secondly, the investment account holders lack the power to influence the use of resources and to verify the degree of risk of management's investments. Unrestricted investment account holders may also not be able to opt out of the accumulation of these funds and be subject to an unwarranted and undisclosed risk.⁹¹⁹ It is therefore asserted that such practices by IFIs to show profits and keep the depositors happy by artificially creating the perception of a profit and making the reporting of such

⁹¹⁷ Diwany (n 711)

⁹¹⁸ Diwany (n 711) and Usmani (n 691)

⁹¹⁹ R Ghayad 'Corporate Governance And The Global Performance Of Islamic Banking', *Humanomics*, 24: 3, 2008, 207-16

returns opaque to the stakeholders is a major systemic governance and regulatory risk.⁹²⁰ As already discussed, the reason for such practices can be attributed to both the pressure of competing with conventional banks and their returns on deposits, and the lack of a well-defined international regulatory environment. It is therefore imperative for the Islamic finance industry to institute measures which will mitigate at least the regulatory and *sharia* compliance risk by moving towards a principle-based regulatory framework.

14 Time-barred *mudarabah* contracts

The third issue relating to the *mudarabah*-based IFI model is the time limits that can be applied to *mudarabah* contracts and the resulting confusion due to a difference of opinion amongst the major schools of thought in Islamic jurisprudence.⁹²¹ As mentioned in the previous chapter, an important feature of the *mudarabah* contract is that, according to *Hanbali* and *Hanafi* schools of thought, it usually functions with an expiry date. This is unnecessary in a conventional contract, much unlike a conventional contract where the contract need not have an end date but will come to an end if there is such a date provided for.⁹²² This then means that the *mudarabah* contract will end automatically after the termination date arrives unless the parties mutually agree to extend that date. However, as with other Islamic finance instruments and concepts, scholars seem to be divided on the particular issue of whether the *mudarabah* contract can be time-barred or not.⁹²³ The *Hanafi* and *Hanbali* schools believe that the *mudarabah* can be time restricted and can come to an end automatically at the end of the designated time period without any

⁹²⁰ Archer and Kareem (n 854)

⁹²¹ Usmani (n 691)

⁹²² Usmani (n 691)

⁹²³ Siddiqui (n 777)

requirement of notice. However, the *Maliki* and *Shafi* schools are diametrically opposed to this stand, unequivocally asserting that a *mudarabah* cannot be time-barred.⁹²⁴

This raises serious issues for the practice of *mudarabah* in the modern IFI and may lead to *sharia* arbitrage and *sharia* forum shopping, whereby the IFIs may pick and choose the *fiqh* (Islamic jurisprudence) that is the most convenient for them, in turn potentially leading to further confusion in the stakeholders dealings with the IFI and reputational risks for the industry. One solution to this particular problem is suggested in the next chapter that deals with regulatory issues; the suggestion follows that in such a scenario the IFI ought to declare which school of thought they are following when allowing a particular financial instrument. Using this method, they can mitigate the stakeholders' concerns and be more transparent in their dealings with stakeholders.

15 Termination of *mudarabah* and the minimum time limit

The fourth issue related very closely to the above issue of the time-barred *mudarabah* is that there also seems to be a paucity of opinion regarding whether there can be a provision for a specified minimum time period before which a *mudarabah* may not be terminated.⁹²⁵ Both of these issues have the capacity to cause serious governance concerns in Islamic banks and commerce in general. The time-barred *mudarabah* may not have a place in the fast-paced commercial context of the modern economy. As mentioned, the division amongst the scholars may cause major legal and *sharia* compliance issues when drafting and enforcing *mudarabah* contracts between parties. Another serious issue may be that the depositors

⁹²⁴ Diwany (n 711) 165

⁹²⁵ Siddiqui (n 777)

(investors) putting capital into IFIs on the understanding that the *mudarabah* deposit may or may not be time barred,⁹²⁶ but at the end of the contract find that there is no clear indication either way. Not all customers of the IFI who would be depositing their money would be institutional investors and therefore may not have the financial and *sharia* knowledge regarding these aspects. This returns us to the issue of transparency of the Islamic finance industry as a whole and has the potential to cause confusion for the customers, the IFI and the regulators. It then falls on the regulators and the banks to divulge as much information as possible and as clearly as possible if they wish to avoid systemic threat to the integrity of the entire industry.

16 An alternative solution to the time barred *Mudarabah*: The contractual stipulations

A possible alternative solution which may be available to the IFI, its investors and customers is the possibility of a condition which can be incorporated into modern Islamic contracts to counter the maximum time limit requirement as espoused by the Hanafi and Hanbali schools of thought. This can be done by relying on the absence of *sharia* rules regarding a minimum time limit for *mudarabah* contracts.⁹²⁷ As a result of there being no minimum time period required before which the *mudarabah* cannot be terminated, the incorporation of such a condition in the contract may bring some semblance of stability and uniformity. For example, a condition may read, for example, ‘this *mudarabah* contract may not be terminated within the first financial year’. This would allow both parties to be legally certain as to at least the minimum duration of the contract and removes some possible uncertainty surrounding this particular aspect. Mulana Taqi Usmani is of the opinion that this term can be

⁹²⁶ Archer and Kareem (n 854)

⁹²⁷ Siddiqui (n 777)

deemed *sharia*-complaint since there is no rule explicitly prohibiting it. Further, this can be facilitated by the doctrine of freedom of contract under Islamic law relying on the following *Hadith* of the Prophet Muhammad: ‘[a]ll the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful.’⁹²⁸

17 The power of terminating *mudarabah*

The final issue surrounding *mudarabah* concerns the unlimited power of the parties to terminate the contract at their pleasure.⁹²⁹ This has the potential to cause commercial and ethical concerns for the *mudarib* (agent). One cause of this stems from the fact that today’s commercial practices are built around long-term relationships rather than the simple barter contracts of fourteen century Arabia and thus they require more long term stability.⁹³⁰ An agent’s investment of time and capital may need a longer maturity period before it starts to bear any returns for the *mudarabah*. This means that the unilateral power of the investor to give a specific notice to terminate the contract as per the *sharia* rules (discussed in the previous chapter) may be excessively harsh for the *mudarib* both in terms of the efforts already put in and the financial gains that he may have been expecting.⁹³¹ It may also cause the *mudarib* (the IFI in this case) to lose reputation and good will in the market if his efforts are prematurely terminated. The nature of the *mudarabah* is such that no specific guarantees can be given by either party under the *sharia* rules pertaining to fixed returns under *riba*. So, a *sharia*-complaint mechanism needs to be devised in a way that mitigates the harshness of the *mudarabah* in this respect.

⁹²⁸ Usmani (n 691) 35

⁹²⁹ M.H.Kamali, *Islamic Commercial Law: An Analysis Of Futures And Options* Islamic Texts Society, Cambridge, UK 2000)

⁹³⁰ Diwany (n 711)

⁹³¹ Iqbal and Mirakhor (n 692)

One possible method of mitigating the lack of transparency and disclosure is ensuring the availability and affordability of financial information which would support monitoring of a business' performance by both private and public stakeholders.⁹³² This would promote transparency and support market discipline, two of the core principles of good corporate governance practices. However, this requires an institutional infrastructure which facilitates the production of accurate financial information, the availability of agents that can interpret and disseminate it, and arrangements to protect its integrity.⁹³³ On all of these counts, the Islamic financial industry faces challenges. Existing limited infrastructure reduces the role that information flows may play in promoting competition and market activities that would induce managers to adopt sound corporate governance practices.⁹³⁴

The accounting and financial information weaknesses inhibit the development of a competitive environment for the Islamic financial sector. The principal weakness is the limited applicability of international financial standards, which in turn reduces accuracy of the information available to stakeholders of IFI. This has the effect of reducing incentives to adopt control mechanisms that would reduce costs.⁹³⁵ Even though the AAOIFI has released its own disclosure standards, the argument is that these AAOIFI standards are not mandatory and have no enforcement or compliance mechanisms; they are largely incorporated voluntarily. It is thus argued that to have a viable and solid enforcement mechanism, the standard setting bodies for Islamic finance need to focus on a principle based meta-regulatory framework in which the

⁹³² R Levine 'The Corporate Governance Of Banks: A Concise Discussion Of Concepts And Evidence' (2004) Policy Research Working Paper Series 3404, The World Bank, Washington, DC

⁹³³ 'Corporate Governance Of Islamic Banks: Why Is It Important, How Is It Special And What Does That Imply', Paper Presented To A Conference On Islamic Finance: Challenges And Opportunities (The World Bank Sector Network And The Islamic Financial Services Board), Kuala Lumpur, 24 April 2006

⁹³⁴ Rodney Wilson, *Legal, Regulatory And Governance Issues In Islamic Finance* (Edinburgh University Press , 2012)

⁹³⁵ Grais and Pellegrini (n 595)

Islamic finance industry may institute licensing certificates, thereby allaying the stakeholders' concerns regarding the compatibility of individual banks with international and *sharia* standards.⁹³⁶

18 *Murabaha*

Whereas the use of *murabaha* financing has allowed IFIs to be more innovative and competitive internationally, it has raised some controversies regarding the use of certain legal mechanisms that are not clear from the *sharia* point of view.⁹³⁷

According to the Islamic finance literature, the *murabaha* as a sale contract is probably the most contentious mode of financial intermediation. A major use of the *murabaha* contract in modern day IFIs is in sale contracts that emulate credit sales by allowing for clients to finance sales via instalments over a period of time.⁹³⁸

Under this practice, the IFI purchases a good from an original seller and then resells the goods to the consumer on instalments over a specified period of time, with a mark-up price, thereby allowing for IFIs to compete with conventional financial institutions.

Some of the contemporary scholars and academics have been highly critical of this practice as being contrary to the principles of *sharia* (*the Mqasid*). These critics consider the *murabaha* contract as being valid only in very limited circumstances. Maulana Taqi Usmani,⁹³⁹ for example, is of the view that *murabaha* financing is valid only when the economy is transitioning to more *sharia*-complaint methods of financing (which are the *mudarabah* and *musharakah*), and he is therefore of the opinion that *murabaha* being used for long term financing under the garb of *tawaruq*

⁹³⁶ This is discussed in more detail in the next chapters.

⁹³⁷ Usmani (n 691)

⁹³⁸ Nethercott and Eisenberg (n 773)

⁹³⁹ Usmani (n 691)

(buy back *murabaha*) to finance anything other than actual assets is arguably not *sharia*-compliant.

19 Enforcement of promise and contractual uncertainty under the *murabaha* sale

Besides the basic ideological incompatibility of the *murabaha* contract in the eyes of some practitioners and scholars, another area of contention is that of the enforceability (or otherwise) of the promise which the customer makes to the IFI before the customer orders a commodity in order for the IFI to be safe, just in case the customer refuses to take delivery of the ordered goods.⁹⁴⁰ This area is not well settled because simple promises under Islamic law do not have the same contractual enforceability as they do under common law or civil law legal systems.⁹⁴¹

The second argument that goes against the use of such promises is the fact that the promise relates to the sale of a good at a future date, and so may give rise to both *riba* (interest based transactions) and *gharar* (uncertainty). This is because both the counter values are deferred, and as we have seen in the discussion of *riba* and *gharar*, this is one of the provisions against which *sharia* is very clear.⁹⁴²

Another practice that is controversial in its nature for IFIs is that they execute a contract of promise with the customer at the outset of the *murabaha* agreement, timed when the customer places an order, ensuring that the customer is bound to the contract and goes through with his order. The reason for such a promise is the fact that in a *murabaha* contract the majority of the risk lies with the IFI because after the

⁹⁴⁰ In the recent past the Islamic scholars have argued that such a promise should be allowed and enforceable under the rule of *sharia* as not allowing such a promise would be over burdensome and unfair for the ifi's. The organisation of Islamic countries (OIC) academy of fiqh (jurisprudence) has ruled in the favour of such a promise being enforceable if it fulfils certain conditions (for a detailed discussion refer to deutsche bank academic paper (on wa'd), Deutsche bank, 2006. (As Quoted in Diwany (n 711) 95

⁹⁴¹ Diwany (n 711) 135

⁹⁴² Saleh (n 119) 19

customer has placed his order, the IFI takes on the responsibility of ordering the goods under their own name and at their own risk.⁹⁴³ If the customer refuses delivery of the ordered goods, the IFI is left with that commodity without any buyer as such. To mitigate this risk, the IFIs execute either a simple promise or attain a security deposit to protect their investments (called a *hamesh jadia* or *urbun* discussed below).⁹⁴⁴ This practice of executing a simple contract of promise is performed separately from the master *murabaha* agreement, which means that it is a separate contract.⁹⁴⁵ This practice of enforcing a promise as a contract also creates a regulatory issue for the IFIs operating in a common law or a civil law jurisdiction, under which such an oral promise is enforceable in a court of law, unlike under *sharia* rules.

Another source of controversy arises due to the timing of the promise, when the promise is made before the actual purchase of the goods:⁹⁴⁶ for goods to be dealt with legitimately under the Islamic law of contract, the goods must be in possession of the party selling them.⁹⁴⁷ It is therefore doubtful as to how a promise of the purchase of goods that are not in the possession of either the beneficiary of the promise (the customer) or the promisor (the IFI) can be held valid under *sharia*.⁹⁴⁸ Further, if such a promise is not valid, how can the IFI ensure that it is not exposed to the unnecessary risk of the client defaulting in buying the requested goods willingly or unwillingly?⁹⁴⁹ However, if the promise is executed and is incorporated

⁹⁴³ Abdullah and Keon Chee (n 702)

⁹⁴⁴ Abdullah and Keon Chee (n 702)

⁹⁴⁵ This is a sort of standard form *murabaha* contract used by most IFI'S, which lays down the terms and conditions of the contract, and is usually formed of a number of different contracts bundled into one master agreement for the convenience of the customers and the IFI.

⁹⁴⁶ Diwany (n 711) 134

⁹⁴⁷ M H Kamali, *Principles of Islamic Jurisprudence*(Islamic Texts Society 2003),100

⁹⁴⁸ Ibid Kamali 104

⁹⁴⁹ D V Abdullah and Keon Chee (n 702) 156. Willingly here means that the customer refuses to take delivery despite being in a condition to do so, unwillingly here would mean where the customer has

in the master *murabaha* agreement and neither party is in possession (actual or constructive) of the goods, that then automatically becomes non-complaint with the *sharia* rules for a valid contract due to the lack of subject matter.⁹⁵⁰ It can thus be seen that the nature of the *murabaha* agreement renders such contracts incompatible with *sharia* at times. The argument follows that despite the commercial convenience of the *murabaha* contract from both a governance and *sharia* compliance point of view, it is far from free of ethical, legal and regulatory issues.

20 Charging the mark-up on a *murabaha*: *Sharia*-compliant or not?

Modern day Islamic finance practitioners and academics have argued that the excessive risk that IFIs are exposed to under the *murabaha* agreement is the justification for the ‘mark-up’⁹⁵¹ or profit that the IFI charges over the actual cost price of the good that the client requests.⁹⁵² However, this practice of charging a mark-up (and enforcement of contracts) remains contentious and needs to be tackled at a regulatory level to bring uniformity into the rules regulating IFIs across the globe.

A major problem arises in practicing a *Murabaha* contract when the client becomes unable or unwilling to pay the instalments under the *murabaha* contract as they become due. The root of the problem is that the IFI, unlike a conventional bank, cannot roll over the debt and charge a higher rate of interest or charge compounded interest.⁹⁵³ Consequently, it has to agree to the price plus the cost at the start of the agreement and has to then abide by the initial quoted sum in spite of any changes in

become insolvent or some other extenuating circumstances force the customer to be unable to buy those goods.

⁹⁵⁰ Kamali (n 926)

⁹⁵¹ Or the cost plus sale price.

⁹⁵² Nethercott and Eisenberg (n 773)

⁹⁵³ Iqbal and Mirakhor (n 692) 91

the conditions. This is because if the *murabaha* payments are allowed to be rolled over and the total price of the goods is to be varied, the contract becomes void on the basis of both *gharar* and *riba*.⁹⁵⁴

The problem is dealt with by contemporary practitioners in a twofold manner. One solution in contemporary practice is that when the customer is unable to make a payment as it falls due, there is an argument that the IFI may charge a fee from the customer as compensation, as a figure representing what would have accrued to the bank in a normal course of business. Thus, the customer should pay the same ratio of profit that normally accrues to the bank for his default in that time period. For example, if the bank in general earns around 5% profit on regular transactions, then the customer should be forced to pay that compensation.⁹⁵⁵ However, this is clearly akin to *riba* and therefore contrary to the precepts of *sharia*. It is therefore not accepted by the majority of contemporary scholars. This is because they feel that it may be used to mimic interest-based lending and would also erode the ethical basis of the financial institution model that IFIs should be following, as this practice allows for exploitation of customers and is clearly against the basic ideology (Maqasid) of business ethics under Islam.⁹⁵⁶ However, the fact that the Islamic finance industry is not as well regulated in non-Muslim countries gives rise to the issue of serious non-compliance with *sharia*, due to lack of external oversight and supervision, further raising systemic governance and regulatory issues. The only possible solution to such *sharia* governance and compliance issues is to have a regulatory framework which can cater for specific *sharia* governance issues internationally keeping true to the stakeholder ethos of Islamic finance.

⁹⁵⁴ Lewis and Algaud (n 722)

⁹⁵⁵ Iqbal and Mirakhor (n 692)

⁹⁵⁶ Resolution No. 53, Vth Annual Session of The Islamic Fiqh Academy, Jeddah, Journal No. 6, 1:447

21 *Arbun and Hamish jiddiya: A sharia governance controversy?*

The second issue that is of a controversial nature (albeit less controversial than the practice of charging a proportionate ratio of loss for default during a particular time period, as mentioned above) is the use of security for the performance by the IFI in a *murabaha* operation.⁹⁵⁷ Even though the AAOIFI has declared the use of security for performance as legitimate, not all *sharia* scholars agree. Some object to the use of *hamish jiddiya* (a security deposit which is taken by the IFI before the *murabaha* contract is concluded) and *arbun* (which is taken from the buyer as part of the price after execution of the sale agreement).⁹⁵⁸ The purpose of this security deposit is to ensure that the IFI is not exposed to unnecessary risks in the event that the customer/purchaser becomes unable (or unwilling) to go through with the purchase as promised (this problem traces back to the issue of simple promises not being enforceable under *sharia*), since the IFI has to purchase the goods on its own account and has to acquire title and possession as required under the *sharia* rules before being able to sell the same goods to the customer who requested the purchase.⁹⁵⁹ Although this practice of *arbun* has been declared controversial by the *Hanafi*, *Maliki* and *Shafi* scholars, the *Hanbali* school of thought has allowed this practice on the pretext it is excessively harsh on the IFI in commercial terms to be left exposed to the risk of customer default, thereby creating an imbalance between the bargaining positions of the parties.⁹⁶⁰ The practice of *hamish jaddiya* has been accepted as valid by most of the contemporary scholars.⁹⁶¹

⁹⁵⁷ Rosly (n 696)

⁹⁵⁸ M Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd, 2007) 117

⁹⁵⁹ Al-Omar and Abdel-Haq (n 712)

⁹⁶⁰ Usmani (n 691)

⁹⁶¹ Diwany (n 711)

Security deposits before/after the conclusion of the contract have been allowed to somewhat limit the IFIs' exposure to risk. Such measures bring symmetry to the risk and return profiles of IFIs, bringing security not only to individual financial institutions but also to the industry as a whole.⁹⁶²

22 *Murabaha* buy-back and *Tawaruq* sale

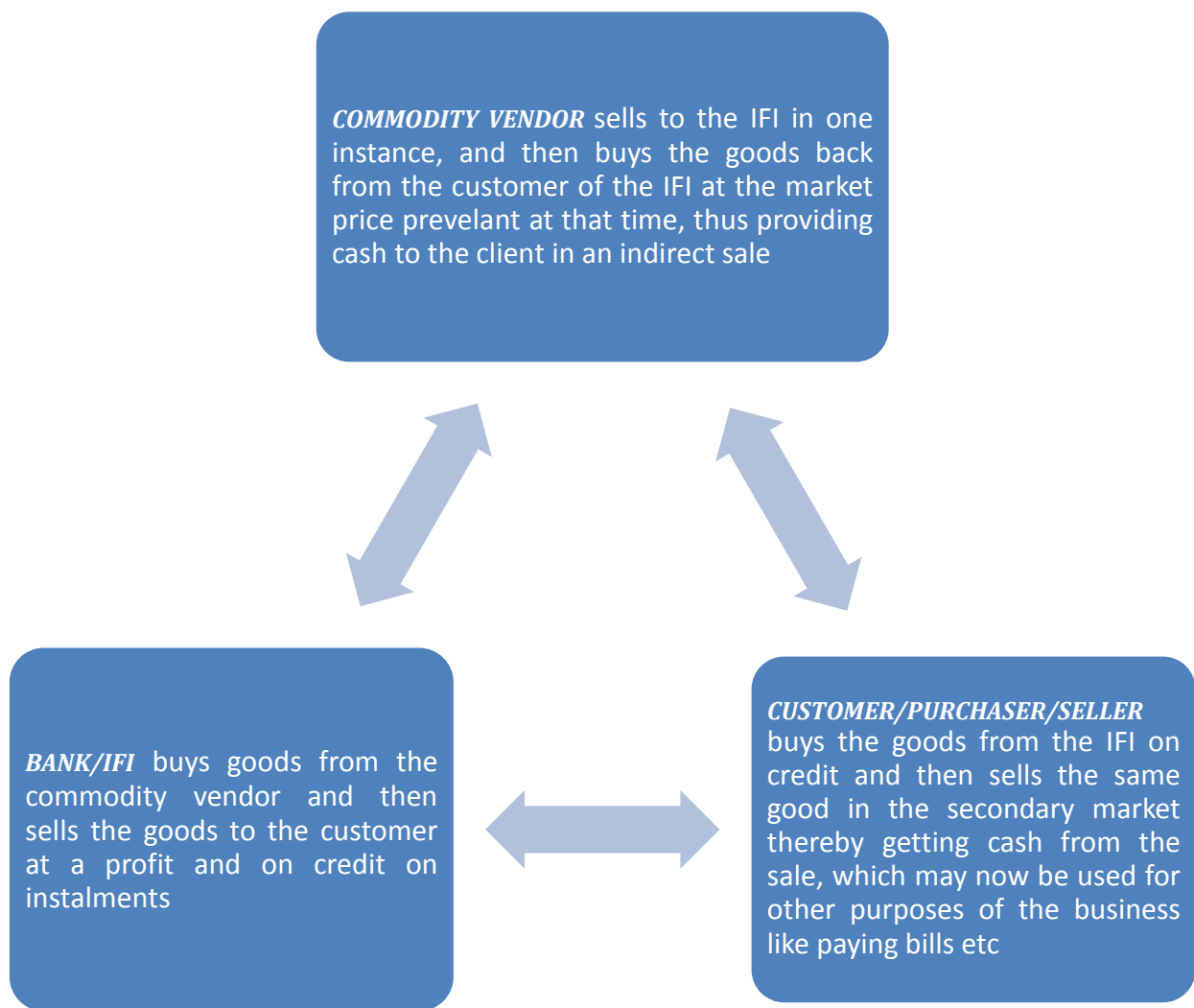
Under the *murabaha* contract, there is also an argument against the IFIs charging a fixed sum over the market price when selling goods to the customer on a deferred basis, with some of the academics arguing that this is a legal method of circumventing the ban on charging interest.⁹⁶³ This argument is more persuasive in the case of special kind of *murabaha* sale, called the *murabaha* buy-back sale or *tawaruq*. However, it should be borne in mind that simply charging a mark-up to make a profit in a simple *murabaha* is in line with *sharia* because the IFI is taking a risk in purchasing the goods without any certainty about their eventual disposal, and thus the bank is justified in charging the mark-up due to its exposure to risk.⁹⁶⁴

The working of a *tawaruq* (buy-back *murabaha*) is explained in figure 5 below.

⁹⁶² Archer and Habib (n 854)

⁹⁶³ Ibid T Usmani 2000 and T Al Diwany 2010

⁹⁶⁴ M N Siddiqi *Partnership and Profit-Sharing In Islamic Law*. Published By The Islamic Foundation 1985



Tawaraq is basically a modified form of the basic *murabaha* contract which is used for monetising the process in order to provide cash (or credit) to the client.⁹⁶⁵ In a simple three party transaction, the IFI receives the request from the client to provide credit facility to it; it then buys some goods (usually precious metal in the open market) via another vendor, and sells those goods to the client under a *murabaha* at a cost-plus, deferred basis on instalments.⁹⁶⁶ The client then sells the same goods back to the vendor on a spot sale and gains the liquid cash for its use. This way, the client is able to gain credit facility via the use of a *murabaha* agreement with the bank

⁹⁶⁵ Yousef (n 827)

⁹⁶⁶ Nethercott and Eisenberg (n 773) 187

using another intermediary (the vendor). The main problem with this transaction arises when the IFI itself is the trader (vendor) of the goods, selling the goods at a profit to the client, and then buying the same goods back on a spot transaction (hence termed the 'buy-back agreement'), which is criticised as being used to circumvent the requirements of the *sharia* in a sale transaction and is criticised for allowing a window to be opened for *riba* transactions.⁹⁶⁷

This kind of *murabaha* contract gives rise to two systemic *sharia* governance problems. The first of these problems is ideological; concerning the question about whether *murabaha* contracts being used as an alternative for credit sales in the form of 'cash loans' and 'credit facilities' can be deemed *sharia*-compliant.⁹⁶⁸ The criticism in this context is that the *murabaha* was never meant to be used as an instrument to support credit sales to clients; rather, it was and should be used as a sale contract whereby the IFI simply purchases the assets that are requested by the clients and then makes a valid sale to the client at a declared and disclosed profit (the mark-up). It is argued that this type credit facility should only be used to cover actual commodity spot sales,⁹⁶⁹ and any other kind of expenditure such as overheads, running finances, and even credit mimicking sales should never be covered by the *murabaha* sale contracts, since it is paramount for credit sales to be divorced from any real economic activity.⁹⁷⁰

Thus, the practice of *tawaraq* - being a derivative of the basic *murabaha* contract - is heavily criticised by some contemporary scholars⁹⁷¹ as being of dubious *sharia*

⁹⁶⁷ Iqbal and Mirakhor (n 692) 92

⁹⁶⁸ Usmani (n 691)

⁹⁶⁹ Usmani (n 691)

⁹⁷⁰ This being one of the basic principles of Islamic economics and finance

⁹⁷¹ Usmani (n 691) 103

compliance.⁹⁷² It is pertinent to note, however, that despite this criticism from a school of scholars, these practices still remain in practice, especially in the East Asian countries. This practice is, for example, accepted in Malaysia by their National Sharia Board.⁹⁷³ This again is an example of *sharia* forum shopping and *sharia* arbitrage, where due to a lack of uniformity between the different schools of thought, the IFIs can adopt practices as per their convenience. This may lead to a race to the bottom situation in regulatory terms, where all IFIs try to move to jurisdictions which are less strict in enforcing *sharia* rules.

23 The LIBOR controversy

The second of the major systemic and *sharia* compliance issues in the *murabaha* transactions is the determination of the profit margin when selling a good to the client. In practice, the profit margins utilised by the IFI are determined by reference to LIBOR (London interbank offered rate), which itself is based on the interest rates used by banks in borrowing money. The criticism is that if LIBOR is the benchmark, then it leaves the entire Islamic finance industry susceptible to fluctuations in the interest rates, and are thus deemed un-Islamic and *haram*.⁹⁷⁴

However, in recent times efforts have been made by the Islamic finance community to set up an Islamic Interbank Interest Rate Index (IIBR), designed as an alternative to LIBOR, and it is hoped this will provide the Islamic finance industry a chance to move away from the use of conventional interest rate indexes.⁹⁷⁵ This, it is argued,

⁹⁷² A statement issued by the Islamic Fiqh council held from 19-23/10/1424 ah (13-17/12/2003 ce) states that this transaction is haram (non-permissible and illegal), and warns banks not to exploit this transaction in ways that are not Islamicly acceptable.

⁹⁷³ http://Www.Bnm.Gov.My/Guidelines/01_Banking/04_Prudential_Std/07_Shariah_Resolution.Pdf

⁹⁷⁴ Diwany (n 711)135

⁹⁷⁵ <http://Thomsonreuters.Com/Site/Islamic-Interbank-Benchmark-Rate/Background/>

will help prevent systemic issues in the Islamic finance industry caused by the use of international interbank interest rates in *murabaha* contracts.

From a corporate governance perspective, it can therefore be seen that the main financial intermediary contracts of *mudarabah* and *murabaha* are fraught with traditional *sharia* issues. It is argued that the major reason for IFIs adopting these financial intermediaries of doubtful *sharia*-compliance is the competitive pressure to mimic the neoliberal shareholder-oriented conventional financial institutions in order to attract customers with better returns. It is asserted that the Islamic finance industry needs to move away from the pure profit-maximising ethos and go back to their roots of being an ethical system of finance catering to the maximum number of stakeholders. The best way to do this in modern day IFIs is to institute a stakeholder corporate governance model both at the macro- and the micro-level.

24 *Sharia* supervisory boards: moving towards regulatory oversight

Another distinct feature that underpins the modern IFI is the presence of a *sharia* supervisory board (SSB). This body (or person) is responsible for the *sharia* compliance of all features of the IFI and consists of *sharia* qualified persons who are employed (as a mandatory obligation) by all IFIs to ensure that all financial instruments and services are in accordance with *sharia*.⁹⁷⁶ These SSBs are an integral part of the modern Islamic financial industry, dealing with issues relating to: the approval/disapproval of financial instruments in line with *sharia* through *fatwas* (religious pronouncements), the disposal of any income as charity attained by the IFI which was not in compliance with *sharia*, determining the levels of *zakat* at the IFI,

⁹⁷⁶ El Gamal (n 817)

and giving advice on the distribution of returns to the shareholders and investment account holders.⁹⁷⁷

From a governance point of view, the role of the SSB in IFIs is extremely important: without the SSB (or a *sharia* qualified person) the IFI cannot be truly *sharia*-compliant. On the other hand, the existence of SSBs also causes some unique corporate governance issues for IFIs. These issues are related to the independence of the SSB, the competence of the SSB, conflict of interest of the SSB, transparency in the working of the SSB, confidentiality surrounding the SSB, agency costs involved in the monitoring and supervision of the SSB, and the possibility of conflict between the opinions of the SSB and the BOD.⁹⁷⁸

One major aspect of the SSB is their ability to affect the management of the IFI, since without the approval of the SSB the IFI cannot effectively operate, creating in essence a two-tiered board, one being the executive board and the other being the SSB. This is something which has caused problems in effectively regulating IFIs; most regulators in non-Islamic jurisdiction are unsure as to how to handle the role of the SSB in context of the corporate governance structure of the IFI.⁹⁷⁹

It is also pertinent to mention that the regulation of SSB's own activities has been a matter of much debate and concern in academic and the practice, especially concerning those IFIs which are working in a secular jurisdiction where *sharia* is not recognised as a valid source of law. This creates two problems: first, the admissibility of *fatwas* as valid legal pronouncements and secondly; the availability of *sharia* qualified persons to carry out the role of the SSB for the IFIs.⁹⁸⁰

⁹⁷⁷ Iqbal and Mirakhor (n 692) 289

⁹⁷⁸ Errico and Farhbaksh (n 590)

⁹⁷⁹ Archer and Habib (n 854) 187

⁹⁸⁰ R Ghayad 'Corporate Governance And The Global Performance Of Islamic Banking', *Humanomics*, 24: 3, 2008, 207-16

The IFI, in order to cater for the SSB, will normally have a two-tiered structure; the main executive board having been elected by the shareholder in the AGM and the SSB as the second board consisting of *sharia* qualified persons who are hired and appointed by the executive management of the IFI. Somewhat foreseeably, this two-tiered structure may result in a continuous tussle of power between the SSB and the BOD, since the two boards are usually working towards different goals. The BOD works towards upholding the profitability of the IFI and maximising returns on the investment of the shareholders⁹⁸¹ and the SSB works towards ensuring that every action is taken in line with the laid down precepts of *sharia*, which should include ensuring that the stakeholders are well catered for and the IFI remains true to the basic ethos (Maqasid) of Islamic finance.⁹⁸²

25 The SSB and the stakeholder-oriented model: the role of remuneration for the BOD

It is at times argued that ensuring *sharia* compliance ought to actually be a part of the executive BOD too since the purview of operations compliant with *sharia* principles is a major part of the basic mission statement of the IFI.⁹⁸³ Also, since the burden of ensuring that the IFI works within its mission statement lies with the executive board, it should automatically be expected that the BOD ensures this aspect. Thus, there should be no conflict between the aims of the SSB and the BOD.⁹⁸⁴ However, the inherent nature of the current corporate governance structure leaves a lot to be desired in this regard. This is primarily because the international

⁹⁸¹ However as will be seen this issue itself is very contentious, since in the IFI there are two different types of equity providers, the shareholders as well as the UIAH. This is dealt in more detail in the next chapter.

⁹⁸² Diwany (n 711)

⁹⁸³ Islamic Finance: Opportunities, Challenges and Corporate Governance Issues', World Bank Seminar, Washington, 24 April 2006

⁹⁸⁴ Omar and Haq (n 712)

financial market is structured in such a way that all executive incentives are based on the ability of the management to maximise returns for the shareholders,⁹⁸⁵ thereby shifting the focus of the BOD to a more profit-maximising approach. This focus of the Islamic finance industry on incentivising their executive boards and other officer based on the profit of the individual IFIs is an issue which needs to be examined at a regulatory level.

In view of the international trend of incentive-based remuneration for the executive officers and board members of financial institutions, it becomes difficult to argue that IFIs should avoid such incentive-based remuneration when the industry needs to attract high-calibre personnel. It is in essence a self-defeating argument for IFIs, since the IFI is premised on following the Sharia principles (*Maqasid*), stakeholder-orientation and social responsibility, but if they do not incentivise the top management adequately, they will not be able to attract the best possible talent. On the other hand, if they do incentivise them as the conventional financial industry does, they will have to forego their ambitions to be stakeholder-oriented and will have to resort to focusing on maximising profits. It is thus argued that the industry needs to determine its own standards in every aspect, keeping in view the basic principles of *sharia* business ethos (the *Maqasid* framework), since using the existing shareholder-oriented forms of governance may lead to IFIs facing systemic risks. This is something which will be discussed in the next chapter.

26 Conflicts of interest between SSBS and executive management.

Next, we shall explore the issue of possible conflicts of interest between the SSB and the executive management/BOD. The SSB, in theory, have the power to veto all

⁹⁸⁵ Wilson (n 913)

measures and financial instruments that they deem non-compliant with *sharia*, but there are questions whether the members of the SSB can truly be considered independent because they are appointed by the board. It is thus argued that the issue surrounding the independence of SSB is a matter that needs regulatory intervention at a national level and an international level.

It is also argued that the powers of the SSB to act as the final arbitrator for matters pertaining to *sharia* issues can also be enhanced by outlining the authority of the SSB in the articles of association of the IFI by designating specified situations in which the SSB would be the ultimate authority. This may also be done by placing such powers on a statutory footing, as is the case in Pakistan's rules and regulations governing the Islamic banking and finance sector.⁹⁸⁶ As a minimum, the powers of SSB should include access to all records and staff, a power to conduct internal audits and a power to demand an explanation from the responsible party in case of any adverse findings. This will need a complete revamp of the current corporate governance framework at the industry level by way of regulatory intervention; otherwise the efficacy of the SSB is going to be left at the mercy of the executive management and the BOD.

27 *Fatwas* and the power of the SSB

Connected to the powers of the SSB, another noticeable issue is the concern regarding the pronouncements of the SSB (the *fatwas*) and their standing as effective pronouncements in the current corporate governance structure.⁹⁸⁷ A *fatwa* is a '[l]egal opinion issued by a qualified scholar on matters of religious belief and

⁹⁸⁶ <http://www.sbp.org.pk/ibd/2004/Cir03.htm>

⁹⁸⁷ Iqbal and Mirakhor (n 692)

practice'.⁹⁸⁸ However, their standing in a jurisdiction where *sharia* is not recognised creates a systemic issue for the Islamic finance industry. With the SSBs currently being powerless to implement any of their rulings in many jurisdictions, it is up to the standard setting bodies to institute mechanism through which these pronouncements can be vetted as well as be enforced. A classic scenario would be where in a non-Islamic jurisdiction there is a conflict between the management of the IFI and the SSB regarding a new product that the IFI wants to launch. If the SSB is of the opinion that the product must not be launched because it is not *sharia*-compliant, but the management still wants to launch it, there are two options open to the members of the SSB: they resign on the basis of their principles or they accept whatever the management says. This latter option is a forced one, because aside from these two options, there is no other mechanism which would currently allow the SSB in most jurisdictions to enforce their opinions. This is aggravated by the lack of recourse to dispute settlement mechanism in such a case, since in most jurisdictions the local judiciary will not enforce *sharia* rulings. Also, under normal corporate law(s) in most common law and civil law jurisdictions, the final decision of the BOD/management regarding the running of the corporation will take precedence over any other opinion. It is thus argued in the next chapter that the Islamic finance industry must have access to specialist alternative dispute resolution (ADR) methods to ensure the integrity of *fatwas*. Without such a framework, it is argued that the *fatwas* will lose their legal standing and the IFIs face a serious reputational risk.

⁹⁸⁸ Wafik, Grais, and P. Mattio. "Corporate Governance And Stakeholders' Financial Interests In Institutions Offering Islamic Financial Services." Stockholm: World Bank, November 2006

To alleviate some of these problems regarding *fatwas*, some jurisdictions have moved towards the concept of centralised SSBs.⁹⁸⁹ For example, in Pakistan and Malaysia the governments have delegated the authority to regulate the Islamic finance industry to a central *sharia* body. This leads to standardisation of *sharia* practices and the resolution of issues through harmonisation at a governmental level. This has also led to the judiciary being proactive with regards to issues surrounding Islamic finance.⁹⁹⁰ However, this approach is not suitable in secular non-Islamic jurisdictions, because having central *sharia* supervisory boards would not be possible at governmental level. This then brings us back to square one with regards to the enforcement of *fatwas* as proper legal opinions.⁹⁹¹

The other issue regarding *fatwas* is with regards to the inconsistencies in *fatwas* between the different schools of thought as well as between different jurisdictions (or even between individual IFIs).⁹⁹² This is an issue of systemic proportion and may cause serious damage to the industry if not dealt with properly at a regulatory level. These inconsistencies pose a unique risk for IFIs as an industry; that of *sharia* forum shopping and *sharia* arbitrage. This is another example of where positive regulatory intervention (or at least monitoring) is required by a singular body (or an amalgam of different standard setting bodies) internationally.

Another solution offered for this difficulty is the gradual codification of *fatwas*, combined with a suggestion that there should be a centralised *fatwa* database available to all stakeholders, including the customers and regulators for easy

⁹⁸⁹ Ibid Grais and Pellegrini

⁹⁹⁰ Example is the detailed decision of the Pakistan supreme court's sharia board regarding the ban on usury and interest based banking.

http://www.supremecourt.gov.pk/web/User_Files/File/JR_Detailed_Judgment_In_Riba_Case.Pdf

⁹⁹¹ M F Khan and Feddad. 'The Growth Of Islamic Financial Industry: Need For Setting Standards For Shariah Application' Paper Presented At The Sixth Harvard Forum On Islamic Finance, May 2004

⁹⁹² Diwany (n 711)

consumption and reference.⁹⁹³ This task can be delegated to an existing international organisation like the IFSB or the AAOIFI, whose purposes already involve the promotion of harmonisation and convergence of *sharia* interpretations. Alternatively, a new organisation could be established to promote and promulgate on the subject matter. Thus, it is suggested in the next chapter that such a function should be carried out by an amalgam of the existing standard-setting bodies (i.e. the IFSB and the AAOIFI) as a supranational regulatory authority with the powers to issues certificates of compliance and issuing licenses (along with the powers to revoke such certificates and licenses if the organisation fails to comply with the set standards) to institutions that intend to work as IFIs. This way, the issues relating to the compliance of predetermined standards can be dealt with at an international level and the international community can move towards a new and more harmonised regulatory architecture for IFIs.

28 Conclusion

It is argued that the corporate governance arrangements of IFIs are currently largely modelled around those of the conventional shareholder corporations, in spite of the explicit mandate to promote social welfare and pursue stakeholders' interests. This configuration leads to a distribution of rights and responsibilities that essentially leaves control with shareholders. The most notable variation in IFIs' corporate governance structure is the presence of a *sharia* board of scholars and a *sharia* review unit that ought to ensure compliance with Islamic law, along with the issue of investment account holders and their standing in the IFI. Such an implementation has far-reaching repercussions for the Islamic finance industry, as discussed in this

⁹⁹³ M.Chapra, and H.Ahmed, "*Corporate Governance In Islamic Financial Institutions*" Occasional Paper No. 6 (Islamic Research And Training Institute: Islamic Development Bank, Jeddah), 2004

chapter. It has also been established that *sharia* compliance decisions affect all IFI stakeholders and thus form the basic governance aspect of any particular IFI and need to be regulated more harmoniously across the globe.⁹⁹⁴

The other aspect of corporate governance for IFIs is the issue of the basic financial intermediary contracts that are being utilised by the modern IFIs. As we have explored, they have certain systemic consequences for the whole industry if not corrected, regulated and governed as per the actual ethos (Maqasid) of Islamic finance. In the next chapters it is argued that all of these internal as well as external governance and regulatory issues can be addressed via a stakeholder oriented principle-based meta-regulatory framework.

⁹⁹⁴ Iqbal, Zamir and Mirakhor. "*Stakeholders Model Of Governance In Islamic Economic System*", Islamic Economic Studies, Vol. 11, No.2 (March 2004), 43-6, 2004

CHAPTER 8: DRAWING A SYNERGY BETWEEN THEORY AND PRACTICE - A MOVE TOWARDS A MORE STAKEHOLDER-ORIENTED REGULATORY FRAMEWORK FOR MODERN IFIs

1 Introduction

Having discussed the internal corporate governance issues in the previous chapter, we can now move to discuss the external aspects of the framework which form a major part of *sharia* governance.

This chapter explores the argument that there can be no single ideal model for regulation of IFIs. Rather, a model that recognises the IFI as operating within a separate sector and sets standards and legislation specific to them is better suited. Rationale for separate arrangements can be found in the enactment of Islamic finance laws in countries that had previously opted for a homogenous regulatory framework, as well as in the creation of specialised Islamic finance regulatory divisions in the regulatory bodies. However, as we will see in this chapter, establishing separate laws or institutions for the regulation of IFIs could be an issue in non-Islamic countries. Further, IFIs seem to flourish even in some countries that do not address the specificities of IFI through specific legislation.⁹⁹⁵ This is the case, for instance, in the UK, Saudi Arabia or Bahrain; where the lack of an IFI-specific legal framework is not synonymous with a neglect of the industry. Conversely, regulators in these countries have shown some willingness to adapt regulatory arrangements whenever needed, guided by the imperatives of fair competition,

⁹⁹⁵ W.Grais, and P Mattio "Corporate Governance and Stakeholders' Financial Interests In Institutions Offering Islamic Financial Services." Stockholm: World Bank, November 2006

systemic stability and investor protection. However, the fact remains that regulators are secular regulators with little or no expertise in Islamic finance, and in view of the fast paced developments in the industry, regulations specific for the Islamic finance need to be flexible, adaptive, dynamic and principles-based. In the current regulatory environment this is not the case. The regulation for the Islamic finance is both lagging behind the industry and is not uniformly applicable throughout different jurisdictions, despite the presence of uniform standards set by two standard-setting bodies: the AAOIFI and the IFSB. The problem lies at the enforcement end of these regulatory efforts.

It appears, therefore, that the suggestions presented in the previous chapter for solving the internal corporate governance problems may form a reasonable solution to the immediate problem. Nonetheless, these suggestions do not resolve the macro-level external regulatory issues and it would ultimately be necessary to find organisational solutions that resolve this and other corporate governance problems that emanate from such external regulatory issues.⁹⁹⁶ In conjunction with mitigating conflicts of interest and other corporate governance issues, regulatory efforts would need to emphasise the transparent and ethical conduct of business. In this regard, the need to ensure transparency and compliance to standards set by an external regulatory mechanism requires streamlining and harmonising efforts. This, it is argued, can be best carried out by a principle-based meta-regulatory framework which focuses on the stakeholder model as an embodiment of the Islamic ethos regarding economics and finance.

⁹⁹⁶ A S Al-Jalahma 'Corporate Governance And Islamic Banking' (3 February 2004), *Islamic Finance Weekly*, Vol. 1, No.22 6-7

2 The regulatory state and the stakeholder theory: laying the ground work for the regulatory framework for IFIs

David Lea, in his writing, insists that the stakeholder rights are best described as moral duties rather than specific legal duties.⁹⁹⁷ The reason that he gives is that since the stakeholders have a claim in the company as moral beings, it is best to define their interests as being informal and imperfect duties rather than special and perfect duties. This is so because whilst these duties are an obligation for the stakeholders, they are also more flexible and can be adopted by the firm or industry according to specific needs of the particular segment of stakeholders. The reason for the preference of stakeholder duties as moral duties rather than legal duties is the fact that once they become legal duties, they would rob most of the normative stakeholder duties of their moral content⁹⁹⁸ and would suffer the same consequences that some laws in the corporate regime do; that is, they become redundant.

Another major reason is that since the list of stakeholders is generally not delineated and since a stakeholder in an organisation can be defined as ‘any group or individual who can effect or is effected by the achievement of the organization’s objectives’,⁹⁹⁹ it would not make sense to define set duties because different stakeholders may be owed different duties. To keep the stakeholder concept viable and of relative utility, it is best to define their rights in the form of a moral obligation from the managers’ point of view.

The other objection to making the stakeholder duties legal duties is the fact that by doing so, the burden of enforcing them would shift to the corporations, which might easily cause the government to relinquish its all-important supervisory role and no

⁹⁹⁷ David Lea, *Stakeholder Theory And Imperfect Duties* in G.J(Deon) Rossow And Alejo Jose G.Sison (Editors), *Global Perspectives On Ethics Of Corporate Governance* (Palgrave Macmillan, 2006)

⁹⁹⁸ David Lea (n 976)

⁹⁹⁹ R E Freeman, *Strategic Management: A Stakeholder Approach* (Pitman, Boston 1984)

longer play a valued part in regulating the corporation. From a regulatory point of view, this loss of the supervisory role of the government would be a catastrophe; the only way the government would ever be able to keep a check on corporate policy would only be when a law is broken, meaning that governmental intervention may come ‘too little too late’. Keeping the government part of the regulatory structure is best for both the stakeholders and the companies because the supervisory role is best performed by the government. Looking at this argument from an international perspective, another aspect becomes clear; by keeping all responsibilities owed to stakeholder groups as uniformalised, imperfect duties the firm may adapt to their particular needs meaning that the corporation would become more dynamic in adapting to different cultural and societal settings.¹⁰⁰⁰

It is thus also argued that the concept of making the stakeholder duties as moral duties can be satisfactorily amalgamated into the business ethics and CSR ideals when the state is made a moral player with regard to outlining the regulatory policies for an industry. Only when the state is itself involved in the regulation and supervision of an industry as a major moral player (or in other words as a stakeholder) can it be possible to make prudential regulations for any industry. So, David Lea’s argument can thus viably be furthered by making the state a moral player while making the stakeholder duties as moral duties. This combination of the state acting as a moral player at a macro-level with corresponding moral duties of the stakeholders at the micro-level can be deemed successful only if used in meta-regulations given by the state in an industry such as Islamic finance. As we have already established in the previous chapters, the Islamic finance industry is not restricted to any one particular jurisdiction, rather operates internationally under non

¹⁰⁰⁰ David Lea (n 976)

uniform rules and principles without any specific enforcement mechanism. As such, the argument of having an effective meta-regulatory framework at a national level can be extended by analogy to the international level and the state's responsibility can be delegated to a supranational regulatory authority like the IFSB and the AAOIFI for an industry like Islamic finance.

3 Meta-regulations: A new avenue for Islamic finance?

Meta-regulation can be defined as 'the proliferation of different forms of regulation (whether tools of state law or non-law mechanisms) each regulating one another and is a key feature of contemporary governance'.¹⁰⁰¹ The concept also holds that law is not the right method to regulate stakeholder rights since it is believed that law will rob the hallmark flexibility of both these concepts. This holds truer for an industry like Islamic finance, since the focus of the industry is on the stakeholder nature and thus needs a flexible approach to regulation.

In other words,

[m]eta-regulation can also entail any form of regulation (whether by tools of state law or other mechanisms) that regulates any other form of regulation. Therefore, it might include legal regulation of self-regulation (e.g., putting an oversight board above a self-regulatory professional association), non-legal methods of 'regulating' internal corporate self-regulation or management (e.g., voluntary accreditation to codes of good conduct, etc.), the regulation of national law-making by transnational bodies (such as the EU), and so on.¹⁰⁰²

¹⁰⁰¹ C Hood, O James, C Scott, G Jones and T Travers, *Regulation Inside Government* (Oxford: Oxford University Press, 1999)

¹⁰⁰² J Jordana and D Levi-Faur, *The Politics Of Regulation In The Age Of Governance* in J. Jordana And D. Levi-Faur (Eds.), *The Politics Of Regulation: Institutions And Regulatory Reforms For The Age Of Governance* (Cheltenham, UK: Edward Elgar, 2004), 1

This shows that even though the legal fraternity has made strides to assimilate the social responsibility of the corporation via legislation and court decisions, the best way to capture the essence of stakeholder duties is by means of meta-regulation.¹⁰⁰³

This thesis argues that it follows that IFIs need to be regulated and governed prudently via meta-regulations where the private sector, the government sector and the international supranational regulatory and standard setting authorities are involved in devising the regulatory framework based on the principles espoused by *sharia(the Maqasid Al Sharia)*. The need to have a prudential, harmonised regulatory framework holds much more importance for the Islamic finance industry than the conventional finance industry. Specifically, this is because the Islamic finance industry's operations transcend different jurisdictions whilst maintaining the same basic ideology and ethos, which causes a non-uniform application of rules and regulations and consequently causes governance and regulatory issues. As a result, harmonisation of the Islamic finance industry's standards is by far the most important issue from a regulatory and governance point of view and needs the input of all those jurisdictions and stakeholders who are affecting and affected by the Islamic finance industry.

What stakeholder theory proponents are normatively trying to achieve via regulation is not to give a one-size-fits-all solution, but rather to elaborate the fact that the stakeholder approach 'points to the need for social controls to encourage the beneficial effects of the institutional behaviours and to regulate or prevent the harmful effects.'¹⁰⁰⁴ Similarly, this perspective resonates with Michael Jensen, who says that the

¹⁰⁰³ P O.Mulbert 'Corporate Governance of Banks,' Law Working Paper N.130/2009, ECGI (European Corporate Governance Institute). August 2009

¹⁰⁰⁴ Wood (n 492)

‘role of the government’¹⁰⁰⁵ is to set up such a system whereby the cost of externalities are minimized, meaning that the cost of one person acting in one particular fashion should not bear a cost on another person. This adds to the normal role of the state (or other regulatory bodies) of ensuring that the contracts that are entered by people and organizations are abided by at all levels, and that the power of enforcement and coercion should remain with the state (or other such designated regulatory authorities).¹⁰⁰⁶

Both Jensen and Wood are focusing on the same point about the role of the government in the affairs of the economy at a macro-level and in the affairs of the firm at the micro-level by means of regulations and laws. This is to ensure the balance that is required in any civilised society between maximising one’s own welfare and ensuring that it is not done at the cost of another. The aforementioned argument should be reiterated here; that for an industry like the Islamic finance industry, where national regulatory mechanisms are not always available, regulation via an international meta-regulatory framework is possibly the best way to balance out the competing interests of the free market mechanism with the need of financial stability for society in general. Thus, by using meta-regulatory mechanisms, an international regulatory framework can be created which will fulfil all the basic requirements for individual IFIs, namely *sharia*-compliance as well as allowing IFIs to operate in jurisdictions which are not Islamic per se. The logical conclusion that follows from these arguments is that the stakeholder point of view is the most suitable for the Islamic financial industry at both a macro regulatory level as well as

¹⁰⁰⁵ By analogy for the Islamic finance industry the international standard setting and regulatory bodies like the IFSB and the AAOIFI

¹⁰⁰⁶ B R Agle, T Donaldson, R E Freeman, M C Jensen, R K. Mitchell and D J Wood ‘Non Rational Behavior, Value Conflicts, Stakeholder Theory And Firm Behavior’ in Dialogue: Towards Superior Stakeholder Theory(2008) Business Ethics Quarterly, Vol 18, Issue 2, 153-190

a micro institution level and provides the necessary uniformity of rules, regulations and enforcement mechanisms that has been missing in the industry to date.

Meta-regulation is specifically well suited for IFIs because of the lack of a coherent single body to oversee the operations and enforcement of regulatory standards of IFIs as an industry. Thus, a principle-based approach with emphasis on substance rather than form (in ideological and practical terms) can be best achieved through meta-regulations with a focus on gauging results rather than rules. Consequently, the international standard setting and regulatory bodies need to ensure that their regulatory framework for Islamic financial institutions is in line with the stakeholder approach so that the essence of the Islamic teachings is comfortably amalgamated with the conventional corporate governance and regulatory practices at both the macro- and the micro-level.

4 The regulatory issues emanating from Corporate Governance theory and Islamic financial theory

According to Iqbal and Mirakhor, the issues to be taken into account regarding the regulatory framework for IFIs are the ‘clarity and enforceability of property rights, the quality of contract law, the efficiency of judicial recourse, [and] the feasibility of quick dispute resolution mechanisms.’¹⁰⁰⁷ All of these issues for IFIs, when discussed from an international or cross-jurisdictional regulatory point of view, can be seen to be systemic as they relate to the essence of Islamic finance. The failure to take into account any of these issues means that IFIs as an industry lose their core Islamic identity and are then labelled as Islamic merely in form and not in substance.

¹⁰⁰⁷ Iqbal and Mirakhor (n 692)

As we have already seen, property in Islamic literature is approached differently from the western perspective.¹⁰⁰⁸ The Islamic perspective of property makes it an inherent social concern, whereas the western point of view espoused by the capitalist neoliberal ideological standpoint makes it an inherent individual right with very little that is owed to the collective.¹⁰⁰⁹ Accordingly, it is argued that the issue of property, along with the issue of enforcement of *sharia* principles (*sharia* governance), is at the heart of the regulatory conundrum of the Islamic financial industry.

5 The aim of the regulatory framework for the Islamic finance industry

It can thus be argued that under the *sharia* principles, the objective and aim of a financial institution is to act as a medium through which wealth is circulated and transferred from that area (or segment) of the economy where it is in abundance, to an area where it is needed. The financial institutions are thus first and foremost facilitators of wealth distribution and then secondly profit-making entities (emphasis is to be put on profit-*making* and not profit *maximising*) under the Islamic concept of a business organisation.

As Islam encourages entrepreneurship and is inherently abhorrent to the hoarding of wealth, the economic systems has to be such that either people voluntarily part with their wealth via investments or are forced to part with their wealth via the obligatory payment of *zakat* (Islamic wealth tax). In view of this macro-level objective of the financial system, it is imperative that a prudential regulatory system is put in place which furthers a management system which caters for the stakeholder nature of the IFI and ensures a risk averse operation of the IFI. However, this task is made difficult for IFIs because of their cross-jurisdictional operations where they are

¹⁰⁰⁸ Chapter 3 of This Thesis.

¹⁰⁰⁹ A Berle and G Means, *The Modern Corporation And Private Property* (New York, Macmillan Publishing Co 1932)

forced to operate for competitive reasons in jurisdictions where *sharia* law and principles may not be recognised. Therefore, IFIs are left without any effective enforcement mechanisms for the principles and rules needed to allow the financial institutions to be 'Islamic' in their true sense.

As a result, the main issue that arises from the external governance of IFIs is the issue of *sharia* governance and the enforcement of standards set by the IFSB and the AAOIFI. This issue is an inherent part of the corporate governance framework for all IFIs and needs the most attention, but at the same time is the most difficult to regulate from a conventional regulator's perspective.¹⁰¹⁰ One of the major reasons for IFIs not having a uniform regulatory regime can be traced back to the issue of *sharia* forum shopping and non-uniformity of the religious pronouncements (*fatwas*) by different *sharia* scholars.¹⁰¹¹ Whilst other generic issues surrounding the corporate governance debate have been dealt with in different regulatory standards as issued by the IFSB¹⁰¹² and AAOIFI, the issue of *sharia* governance still remains a contentious issue primarily due to a lack of any viable internationally applicable enforcement mechanisms. There are many instances where the schools of thought have differed over the major issues and this in turn has allowed different IFIs to abide by the different pronouncements of scholars from different schools of thought, leading to uncertainty at both the regulatory as well as individual institution level.¹⁰¹³ Thus, it is argued that the IFIs need a double layered *sharia* governance oversight and supervision framework: the first layer being external *sharia* governance framework instituted either by national regulators or an international supra national regulatory body; and the second being internal *sharia* governance

¹⁰¹⁰ L Errico and M Farhbaksh 'Islamic Banking: Issues In Prudential Regulation And Supervision' (1998) IMF Money And Exchange Department, Wp/98/30, Working Paper

¹⁰¹¹ Iqbal and Mirakhor (n 692)

¹⁰¹² IFSB Standard-10 and Other Such Standards.

¹⁰¹³ Islamic Banker, 'Creating Best Practice In Shariah Advisory' Issue No.78, July 2002

framework instituted by the IFIs themselves. Both of these can be achieved through a principle-based meta-regulatory framework which encourages *sharia* compliance at the macro-level.

6 The current regulatory framework: the three approaches

The regulation of IFIs thus becomes strategically important when discussing the external *sharia* governance framework. It may therefore be stated that there is a need for regulation to achieve public good for society and the regulation needs to be framed in such a way that enhances the climate for investment and trust in the markets both in Islamic countries and in international markets.¹⁰¹⁴ The biggest challenge for IFIs as an industry is to formally put in place a framework whereby a unified system of *sharia* governance at macro-level is put in place while maintaining the IFI's compatibility with conventional regulatory and governance requirements. This is complicated by a number of factors, of which *sharia* forum shopping and *sharia* arbitrage are the most systemic from a *sharia* governance perspective. This is followed by the fact that IFIs operate in different jurisdictions, which gives rise to the corporate governance issues discussed in the previous chapters as well as cross-regulatory issues where the IFIs operate. These jurisdictions can be divided into three distinct groups for the purposes of this thesis.¹⁰¹⁵

a. The first group

The first group is formed of those jurisdictions which recognise *sharia* as a valid legal source of law and allow legal rulings by *sharia* boards and scholars to be endorsed and accepted in the local judiciary. Countries which fall into this category

¹⁰¹⁴ U Chapra and I Khan (n 891)

¹⁰¹⁵ This distinction is by no means water tight and non-exhaustive. The purpose of highlighting these three distinct regulatory approaches is to highlight the en vogue regulatory approaches and their advantages and shortcomings.

are Pakistan, Sudan, Malaysia and Iran. These jurisdictions will have in place a central *sharia* regulatory authority or a body that is recognised both by the legislature and judiciary. These jurisdictions don't have any problem in supervising and regulating the *sharia* aspects of IFIs both externally and internally. The distinctive feature of these jurisdictions is that they will have a central regulatory authority that can give verdicts about the *sharia* standing of a particular financial instrument, contract, transaction and any internal supervisory regime in place. In summary, they regulate any and all aspects relating to the *sharia* supervisory board and any religious pronouncements that they may give pertaining to an IFI's operation. This can be translated to mean that *sharia* governance is dealt with by the central regulatory body. In essence, these jurisdictions have a more 'top down', rule-based approach whereby the central bank (or the appropriate department of the government) continually regulates, monitors and licenses the IFIs. The advantage of this particular approach lies in the certainty for IFIs in knowing exactly what rules and procedures they need to follow. Secondly, the issue of compliance of the regulatory standards set by the central regulatory bodies is also handled by such bodies with the help of the local judiciary and other national dispute settlement processes, therefore instilling confidence in the general public and allowing IFIs to easily follow mandatory governance standards. For example, in Pakistan the Islamic finance industry is regulated both by the State Bank of Pakistan (SBP)¹⁰¹⁶ and the Securities and Exchange Commission of Pakistan (SECP).¹⁰¹⁷ The SBP handles all Islamic financial institutions like banks,¹⁰¹⁸ whereas the SECP handles all *musharakah* and *mudarabah* companies. Both set out detailed specifications for all activities ranging from traditional corporate governance standards for voting at the

¹⁰¹⁶ <http://www.sbp.org.pk/departments/ibd.htm>

¹⁰¹⁷ <http://www.secp.gov.pk/>

¹⁰¹⁸ <http://www.sbp.org.pk/departments/publications.htm>

AGMs, the role of the BODs, to remuneration of the executives, the appointment of the *sharia* supervisory board,¹⁰¹⁹ the issuance of *fatwas*, the acceptability of new financial instruments and capital requirements.¹⁰²⁰ The other distinct aspect of the Pakistani (and other similar jurisdictions) regulatory approach is the proactive role that the judiciary plays in dealing with *sharia*-related issues. The judgement of the Pakistan Supreme Court regarding the ban on *riba* and Islamic banking in general is considered as a great judicial achievement laying down the ideological frontiers for modern day Islamic finance practices.¹⁰²¹ In essence, both *sharia* governance and corporate governance issues are handled by the central authorities, leaving very little room for individual IFIs to manoeuvre in terms of creativity. The other positive aspect of the Pakistani regulatory approach is the fact that the SBP has adopted many of the international regulatory standards set out by the IFSB and the AAOIFI, which means that the regulation of IFIs is already in line with most of the IFSB and AAOIFI standards, bringing uniformity into the regulatory framework.¹⁰²²

Whilst this regulatory approach works well in jurisdiction such as Pakistan where *sharia* is recognised as a legal authority, such a regulatory approach cannot be integrated at a more international level where IFIs operate in jurisdictions without provision for a central regulatory authority accepting *sharia* as a separate and distinct legal system, from the prevalent legal system nor a judicial system that accepts *fatwas* as possessing legal standing. This means that IFIs are not deemed as separate and distinct entities in the eyes of the law and are dealt with under the same regulatory regime as normal financial institutions. As a result, there is a definite need for a different regulatory approach than the rule-based approach as practiced in

¹⁰¹⁹ <http://www.sbp.org.pk/ibd/2004/Cir02.htm>

¹⁰²⁰ <http://www.sbp.org.pk/Departments/Pdf/Strategicplanpdf/Strategy%20Paper-Final.Pdf>

¹⁰²¹ [http://www.supremecourt.gov.pk/Web/User_Files/File/JR_Detailed_Judgment_In_Riba_Case.Pdf](http://www.supremecourt.gov.pk/Web/User_Files/File/JR_Detailed_Judgment_In_Riba_Case.pdf)

¹⁰²² <http://www.sbp.org.pk/ibd/2004/Cir02.htm>

Pakistan, since not all jurisdictions will have made legislative and regulatory changes to accommodate Islamic financial Institutions along the same lines as Pakistan or Malaysia.

b. The second group

This brings us to the second group of jurisdictions. These are those jurisdictions which do not have a separate central regulatory authority which supervises the running of the IFIs yet still recognise *sharia* as a valid source of law for IFIs. Therefore, these jurisdictions provide for regulation through some legislative or regulatory means but do not go as far as providing a central *sharia* authority to oversee the operation of the IFIs and instead accommodate the Islamic financial institutions within its existing regulatory framework. Kuwait is a good example of such a jurisdiction where the legal code provides for *sharia* to be the dominant legal source for all aspects.¹⁰²³ However, it then explicitly states through another decree that the *sharia* principles will not be mandatory for commercial purposes¹⁰²⁴ whilst also providing a definition of an IFI¹⁰²⁵ and allows them to operate under *sharia* principles and requires the bank's assembly to appoint a *sharia* board in accordance with principles laid down by the AAOIFI.¹⁰²⁶

The other distinct feature for the regulatory approach by jurisdictions such as Kuwait is the issue of dispute settlement, since there is no central *sharia* body to oversee the operations of individual IFIs and any dispute arising pertaining to *sharia* is to be dealt with by the *fatwa* board in the Ministry of Awqaf and Islamic affairs.¹⁰²⁷ Nevertheless, there is no recourse to the mainstream judiciary as is the case in Pakistan, Malaysia and Iran. The responsibility of such a referral falls on the BOD of

¹⁰²³ Z Hasan, *Sharia Governance In Islamic Banks* (Edinburgh University Press Ltd, 2012) 212

¹⁰²⁴ Commercial Code Of 1981 Article 102

¹⁰²⁵ Central Bank Of Kuwait Law No. 32, Article 86

¹⁰²⁶ Z Hasan (n 1023) 214

¹⁰²⁷ Z Hasan (n 1006) 187

the IFI,¹⁰²⁸ thereby maintaining the decorum of a traditional BOD being the main decision-making body of the IFI. Consequently, the corporate governance framework is essentially that of traditional Anglo-American corporate governance.

This structure of regulation and governance provides IFIs with a flexible environment to operate without there being a central rulemaking body to oversee their operations. However, at the same time there is an acceptance of Islamic financial institutions as separate entities from normal financial institutions and thus a limited parallel system for the IFI is provided. This is different from the regulatory practices of jurisdictions that fall in the first category like Pakistan and Malaysia in that there is no central body that makes rules for IFIs. Nonetheless, where a financial institution is set up as an IFI, the law recognises it as such and provides for a separate regulatory regime under the Ministry of Awqaf and Islamic Affairs.¹⁰²⁹

Therefore, IFIs are afforded some flexibility and are permitted to rely on the non-judicial administrative bodies and legislative intervention as and when the need arises. However, this regulatory approach may not be completely suitable for IFIs working in all jurisdictions in an international context. The reliance on a body such as the Ministry of Awqaf and Islamic Affairs, as well as recognition by the legislature, means that IFIs are recognised as separate and distinct entities that are to be dealt with separately by the state, *fatwas*, religious pronouncements regarding the *sharia* acceptability (or otherwise) of operational issues and the recognition of the legal validity of governance structures within individual IFIs. This gives these jurisdictions the advantage of operating in a more flexible regulatory environment than the more rule-based centrally controlled first group of jurisdictions like Pakistan, Malaysia and Iran.

¹⁰²⁸ Z Hasan (n 1006) 190

¹⁰²⁹ Central Bank Of Kuwait Law No. 32, Article 86-100

c. The third group

The third group of jurisdictions includes those where there is no provision for recognition of *sharia* principles and the regulation of IFIs is mostly carried out under secular regulations and law with some concessions given to IFIs (specifically for taxation purposes) just to encourage them to keep operating in that jurisdiction. The best example of such an approach is the UK's attitude towards IFIs.

The UK, with its historically dominant position in world finance and an equally strong legal and judicial system, has grappled with the regulatory issues surrounding Islamic finance for some time now. The main regulatory authority at the time of starting this thesis was the FSA,¹⁰³⁰ which had published some basic policy papers detailing the working of IFIs and had made some regulatory inroads into recognising and allowing IFIs some permissiveness in very limited aspects like taxation and deposit protection.¹⁰³¹ However, since the FSA and its predecessors are all secular regulators with no knowledge and expertise of *sharia*, the regulatory regime has not been adapted to incorporate the unique religious nature of IFIs. Nonetheless, a number of endeavours have been made by the HM Treasury and the FSA to allow for certain tax exemptions for Islamic house mortgages; allowing for waiver of stamp duties when dealing in *murabahah* home financing transactions; and other

¹⁰³⁰This has now been replaced with FCA and PRA. It is assumed for the thesis point of view that no significant policy changes have been made since the replacement of FSA and Islamic finance continues to have the same status as had been under FSA's regime.

¹⁰³¹Deposit protection which forms the back bone of the consumer banking here in the UK cannot be applied to IFI's since the operation of IFI'S current accounts are structured as *mudarabah* contract between the bank and the customer/ depositor, which in essence is based on a pure profit and loss sharing contract, with no possibility of allowing the ifi to guarantee any sort of return or protection of the capital invested.(refer to chapter 4 regarding Islamic financial instruments for a more detailed understanding of *mudarabah* contracts.). To overcome this aspect for investment contracts the FSA allowed the IFI's to allow the customers to sign a document stating that they did not want to abide by the statutory deposit protection thus allowing for the contract to remain within the ambit of sharia principles regarding finance.

such specific areas of Islamic finance.¹⁰³² These exemptions given by the legislature, though very encouraging, do not go far enough to help in the regulation of IFIs as distinct from conventional financial institutions. Keeping in view the fact that IFIs intend to compete internationally with conventional financial institutions, it becomes clear that IFIs will have a competitive disadvantage in many regulatory aspects when operating in secular jurisdictions wherein the legal system does not recognise *sharia* as a valid source of law. An example of this is the case of *Beximco Pharmaceutical vs Shamil Bank of Bahrain EC*, wherein the English courts refused to enforce the contract since it was too vaguely stated in the terms of the contract that the governing law was to be the 'principles of the glorious sharia'.¹⁰³³ The courts stated that the term 'glorious sharia' was too vague to be given any effect, demonstrating the kind of legal and regulatory issues faced by the IFIs in secular jurisdictions. Thus, this approach is obviously unsuitable for the Islamic finance industry.

7 The regulatory debate and the aim of Islamic finance: regulating on principles

The other major issue that may arise in a jurisdiction like the UK in the context of regulation of IFIs are the issues of *sharia* supervisory boards. According to traditional and contemporary *sharia* scholars, the religious aspects of the IFI's operation are to be the exclusive domain of the SSB,¹⁰³⁴ in that their verdict on a particular practice or transaction is to be final and mandatory (except where legislation allows for a review of such pronouncement by a higher *sharia* scholars

¹⁰³²Whereby there are two sales of the house, the first one by the bank and the second one from the bank to the customer at a mark-up, there by originally it would have attracted two stamp duties, making it extremely expensive for the customer to buy an Islamic mortgage, thereby making it financial unviable for the customer to buy from IFI and thus making IFI's unattractive and unable to compete with conventional mortgage lenders

¹⁰³³*Beximco Pharmaceuticals Ltd And Others V Shamil Bank Of Bahrain EC [2004] EWCA Civ 19*

¹⁰³⁴A Qarni, 'Regulatory Controls Of Islamic Banks By Central Bank And Islamic Banks In The 6th Expert-Level Meeting On Islamic Banking' (1990) (May 26-28, Bahrain), Under The Auspices Of Bahrain Monetary Agency. The Organization of The Islamic Conference

body, as is the case with the Islamic banking department in the State bank of Pakistan).¹⁰³⁵ However, in the case of SSBs operating in IFIs in the UK, their role has been restricted to being merely advisory, since identifying them as having an executive role would mean that the SSB would come under the purview of the ‘fit and proper criteria’ of the FSA and also become liable under the general duties owed by directors under sections 170-177 of the Companies Act 2006. The SSB being labelled as merely advisory has very far-reaching knock on effects: the IFIs present in UK are basically operating without any effective *sharia* supervision and enforcement and therefore may lead to a product being approved by the IFI’s BOD which may not be *sharia*-compliant, which is a systemic reputational risk for the Islamic finance industry as a whole.

The other important issues related to the SSB are: the regulation of their appointments, their terms of contracts, their remunerations and their qualifications.¹⁰³⁶ All of these issues emanate from the fact that without a proper regulatory oversight, IFIs may not be able to operate with as much confidence as they would in a jurisdiction like Pakistan or Kuwait, wherein both the legislature and the judiciary have acted proactively to establish a system of regulatory oversight by way of positive intervention.

It is therefore argued that from a corporate governance point of view, the issues pertaining to the SSB can be divided into the following four aspects: transparency and independence, confidentiality, competence and disclosure.¹⁰³⁷ The argument follows that all these aspects can be handled well under an international meta-

¹⁰³⁵ <http://www.sbp.org.pk/Departments/Ibd.Htm#H1> (Departmental Objectives 5 And 6)

¹⁰³⁶ A Safieddine ‘Islamic Financial Institutions And Corporate Governance: New Insights For Agency Theory’ (2009) *Corporate Governance: An International Review*, 17(2): 142–158

¹⁰³⁷ L Errico and M Farhbaksh ‘Islamic Banking: Issues In Prudential Regulation And Supervision’ (1998) IMF Money And Exchange Department, Wp/98/30, Working Paper

regulatory framework which focuses on the unique stakeholder nature of the Islamic finance industry.

The biggest challenge for the Islamic finance industry in general, although more prevalent for those operating in jurisdictions which do not recognise the separate nature of *sharia* as a source of law for IFIs, is to instil confidence in the general public that the IFI is actually 'Islamic' in essence and not just an 'eye wash'. As a consequence, it is imperative that a regulatory regime is put in place which can provide the necessary support for the Islamic finance industry as a whole. Moreover, this should be a regime which is principle-based and goal-oriented so that rather than relying on rules, the local regulators can easily and flexibly apply such principles which facilitate the working of the IFIs in an environment where there is transparency in their operations. This should entail clearly defined *sharia* aspects so that the public is aware and well-informed in addition to a regulatory regime which ensures prudent risk management to ensure proper appointments to the SSB and other office bearers. It should also allow for religious pronouncements by *sharia* scholars capable of incorporation into the overall framework of the IFI's operational ambit.

9. Conclusion

It is argued thus that such a proper regulatory regime for the Islamic finance industry can only be made possible when the governance structure of individual IFIs are also structured to strongly incorporate the business ethics and CSR model as espoused by the stakeholder corporate governance theory, and the governance structures depart ideologically from the neoliberal profit maximising ethos of the Anglo-American corporate governance model, with profit-making to be seen as a

means to an end and not an end in itself. The regulatory framework for IFIs should be focused on principles of upholding the unique perspective of property rights as set out under the *sharia*, focusing on the social, economic and legal needs of the whole range of stakeholders rather than just shareholders and creditors.

The high amount of divergence in regulatory practices across the globe for IFIs, coupled with the failure of individual IFIs to uniformly abide by corporate governance standards every time,¹⁰³⁸ logically leads to a strong case for a regulatory framework capable of taking into account the specificity of IFIs, whilst simultaneously maintaining enforcement mechanisms that do not stifle the (relatively new) industry and still maintain the cultural aspects of individual IFIs. In this regard, it is argued that a unique regulatory framework with a focus on principles of Sharia is to be instituted by the industry at an international level. For this to be a practical framework, the normative values of Islamic finance (*Maqasid*) have to be made the focus and the regulatory framework ought to be principle and goal/performance based.

¹⁰³⁸ A S Al-Jalahma 'Corporate Governance And Islamic Banking' Islamic Finance Weekly, Vol. 1, No.22 (3 February 2004), 6-7

CHAPTER 9: RECOMMENDATIONS AND CONCLUSION

1 A goal and principles based meta-regulatory framework for Islamic finance.

The terms “goal-based” and “performance-based” regulation tend to be used interchangeably. In either goal-based or performance-based regulation, the regulation does not specify the means of achieving compliance, but rather sets out goals that allow alternative ways to achieve regulatory compliance.¹⁰³⁹ Sometimes, these regulations promote or encourage the use of management systems with a continuous improvement cycle to move a company to and beyond barebones compliance with a regulatory goal. The other major characteristic of a performance-based regulatory framework is that it places more importance on reviews, inspections, audits and their control, frequency and timing. The latter are underpinned by a determination of where the board's resources should best be focused. Tied to this regulatory approach is the use of performance indicators to assess relative levels of regulatory compliance by the regulated entities.

It is thus argued that a meta-regulatory framework which is ‘smart’,¹⁰⁴⁰ proactive, flexible and responsive needs to be instituted for the Islamic finance industry.¹⁰⁴¹ It is also recognised that the international standard-setting agencies like the IFSB and the AAOIFI, which have been publishing best practices and guidelines, need to be fully involved in the institution of this new international regulatory framework. It is

¹⁰³⁹ C Ford ‘Principles-Based Securities Regulation In The Wake Of The Global Financial Crisis’ (2010) 55 McGill L.J. 257

¹⁰⁴⁰ C Coglianese and Evan Mendelson ‘Meta-Regulation And Self-Regulation,’ University Of Pennsylvania, Penn Law School Public Law And Legal Theory, Research Paper No. 12-11

¹⁰⁴¹ Jassar Al Jassar ‘Regulatory Environment And Strategic Directions In Islamic Finance’ (2000), Proceedings Of The Fifth Harvard University Forum On Islamic Finance: Islamic Finance: Dynamics And Development Cambridge, Massachusetts. Center For Middle Eastern Studies, Harvard University 161-163

also pertinent to mention that the gap between the set standards and their actual application in practice lies at the enforcement end; at the moment there is no effective means of enforcement for the standards set out by both the IFSB and the AAOIFI at the international level for the industry. The best method of enforcement is to incorporate these standards into the national regulatory framework of the individual countries, however as we have already seen, such an approach is impractical for countries which do not accept *sharia* as a valid and separate source of law, which leaves many of the IFI's internationally under regulated and under supervised.

For this aim of an effective enforcement mechanism to be attained, the comity of nations that allow IFIs to operate within their jurisdictions need to agree on common enforcement standards as well as develop guidelines in their frameworks so that a heightened sense of importance is placed on licensing, reviews, inspections and audits. To achieve this purpose, the major task of the international standard-setting bodies (the IFSB and AAOIFI) should be to expand and to develop performance indicators to assess relative levels of regulatory compliance in such a way that is principle and outcome focused and takes into account the basic principles of *sharia* governance(the *Maqasid*). The indicators ought to deal with both *sharia* governance as well as conventional corporate governance standards for financial institutions, which may be borrowed from well-established standard-setting bodies like Basel Accord or the OECD and then customise specific standards tailored to the needs of the IFI. The purpose of this principles-based framework will be to act as supplementary standards for *sharia* compliance and not in lieu of local national regulations. In the case of a conflict between conventional governance and regulatory standards, the IFI should have the freedom to decide which standards they

intend to apply if the conventional governance standards are stricter than those proposed by the IFSB or the AAOIFI. In case of national regulatory standards being more lax than those set out by the IFSB and AAOIFI, the IFI must opt for the *sharia*-compliant option.

The need for this principle based meta-regulatory framework stems from the fact that a rule based punitive framework (as instituted in Pakistan) cannot work across the globe for all IFIs. Further, the absence of expertise and sometimes the inability as well as unwillingness of local regulators to devise an appropriate and separate framework for IFIs (as seen in the UK-based regulatory model) might allow some IFIs to operate either in a regulatory vacuum or a regulatory environment that may even force them to be regulated under conventional regulations and rules. This leads to *sharia* compliance issues which may lead to the systemic failure of the whole industry.

2. Policy recommendations: a move towards a principle-based regulatory framework.

It is in light of the foregoing discussion regarding the regulatory and corporate governance issues that this thesis argues that the best enforcement mechanism from a regulatory perspective for IFIs is a system of certifications for such financial institutions which wish to operate as IFIs. In this regard, the two leading standard-setting bodies (the IFSB and the AAOIFI) should be given the mandate to issue ‘certificates of compliance’ for all IFIs wishing to operate as *sharia*-compliant institutions. These certificates of compliance would be recognition of the fact that the financial institution is indeed operating as an IFI and has complied with all the standards laid down by either the IFSB or AAOIFI (whichever standard is chosen by

the jurisdiction). These certificates will give validity to the *sharia* aspects of the IFI and should be aimed to instil confidence in the stakeholders that are dealing with the IFI.

These recommendations are premised on the recognition that the Islamic finance industry has expanded its operations in the recent past and are no longer restricted to Islamic countries, and consequently need a more harmonised regulatory framework that can be applied uniformly to all IFIs. This issue is coupled with the requirement of having an effective enforcement mechanism for the regulatory standards, which is made all the more difficult because of the cross-jurisdiction operations of the IFI. It is for this reason that no one national regulatory and enforcement mechanism can be deemed sufficient. Thus, the best way to ensure compliance with the standards of the AAOIFI and the IFSB is to give these bodies the power to issue and revoke these certificates of compliance, which would allow the IFIs' stakeholders to function confidently knowing that the particular IFI is actually *sharia*-compliant and is following good corporate governance practice(s). Following this section are some of the basic policy recommendations that this thesis deems appropriate for the aforementioned regulatory issues.

a. Cooperation with national regulators

For such a regulatory framework to be successful, it is imperative that the national regulators are willing to accept these standards as decisive on all things *sharia*, especially in such jurisdictions where *sharia* is not an accepted as a valid source of law. It is argued that national regulators should be encouraging and facilitating such IFIs in obtaining these 'certificates', as these will give a boost to the local IFI in terms of confidence in their operations as well as encouraging more competition

amongst them. This will translate into tangible financial results in the long-term for the country's financial system.

b. Instilling confidence in the public: a service to the stakeholders

Along with increasing transparency and uniformity of *sharia* governance standards, these certificates would instil confidence in the customers and other stakeholders that the IFIs in their particular jurisdiction are actually *sharia*-compliant. Take the example of the UK, where HM Treasury has categorically stated that they would not be following any one particular jurisdiction's example in devising a regulatory framework for the IFIs operating there, but are willing to accept certain AAOIFI standards.¹⁰⁴² The other extreme is the example of Pakistan where, despite having a designated department for regulating the Islamic finance industry in the State Bank, the regulators often borrow standards from both the IFSB and the AAOIFI and incorporates them into the local regulatory framework.¹⁰⁴³ This shows that both kinds of jurisdiction; those that have instituted a separate regulatory framework for the IFIs like Pakistan and those like the UK, who have not instituted a separate regulatory framework, are in any case utilising the regulatory standards given by IFSB and AAOIFI. It is thus argued that these standard-setting bodies should be given more enforcement powers via the ability to issue and revoke these 'certificates of compliance' if the Islamic finance industry has to become risk-free and harmonised across the globe.

c. The criterion for issuance of the certificates of compliance: a *sharia* principle based criteria

¹⁰⁴² Zulkifi Hasan (n 1006) 135

¹⁰⁴³ <http://www.sbp.org.pk/tbd/2009/C1.htm>

These certificates of compliance should be based on the following operational aspects of the financial institutions: the *sharia* compatibility of the IFI's operation, their governance framework (including the appointments of SSB and the apportionment of the powers and duties of the board of directors and the SSB), dispute resolution mechanisms, the decision-making process of the SSB and their *fatwa* pronouncements, information disclosures, and *sharia* compliance audit processes. Besides *sharia* governance compliance, the other criterion should be the adherence to the best practices of corporate governance for IFIs as already published by the IFSB and the AAOIFI.¹⁰⁴⁴ These have been tailored to the specific needs of IFIs, thereby ensuring both *sharia* governance and conventional corporate issues are catered for.

d. Keeping them *sharia*-compliant: the process of *sharia* audits

After the initial issuance of these certificates, the international standard-setting bodies should be given the authority to carry out *sharia* and performance audits biannually (or annually) to maintain a supra supervisory role over the banks. However, the requirement of obtaining these certificates of compliance should not be in conflict with the regulatory arrangements of the jurisdiction where the IFI is operating. As discussed, this certificate of compliance should be supplementary requirements for the sake of the stakeholders involved to instil the confidence that the IFIs are not only *sharia*-compliant but also follow conventional best practices regarding information disclosure, corporate governance, auditing, reporting and human resource policies. These certificates of compliance are to be taken as assurances to the stakeholders regarding the IFIs so that they stand as a sound, well

¹⁰⁴⁴ [Http://Www.Aaoifi.Com/En/Standards-And-Definitions/Shari%E2%80%99a-Standards/Governance-Standards.Html](http://www.aaoifi.com/en/standards-and-definitions/shari%E2%80%99a-standards/governance-standards.html)

regulated financial institution that is also *sharia*-compliant. Also, this method of regulation is in line with the meta-regulatory nature of the supervisory framework needed for the Islamic finance industry, since by instituting the mechanism of certifications by the IFSB and the AAOIFI, the Islamic finance industry is allowed to self-regulate as well as delegate a supervisory role to the IFSB and AAOIFI to oversee such self-regulation of IFIs.

e. Agency costs and revocation of certificates of compliance

It is also recognised that this would mean increasing agency costs for IFIs, especially those IFIs which are working in countries like the UK and the rest of the non-Islamic world where there is neither a possibility of allowing for a special concession at the regulatory or state level for IFIs nor a judiciary willing to accept *sharia* as a valid source of law. To add to this problem, there is also a dearth of suitably qualified *sharia* scholars in such jurisdictions. It is thus argued that the initial costs of obtaining the compliance certificates issued by the international standard-setting bodies, which should be borne by the IFIs themselves, will eventually be balanced out by the confidence that is instilled in the stakeholders as well as local regulators. In turn, this would mean increased financial stability and consequently less chance of bank defaults and bank runs for the Islamic finance industry as a whole. Upon considering both the possibility of corporate governance or *sharia* governance failure and the alternative of the cost of monitoring the IFI by a *sharia* body like the IFSB and/or the AAOIFI, it is likely that a cost-benefit analysis will favour the latter. This is so because allowing an IFI to operate without proper *sharia* compliance is likely to lead to a loss of confidence by the consumers, customers,

regulators and creditors, and may lead to a systemic failure of the whole Islamic financial industry.

It is therefore argued that the national regulators across the globe need to develop mechanisms to advance cooperation efforts with the IFSB and AAOIFI in order to facilitate the growth of IFIs in their jurisdiction. The measures for their cooperation with the IFSB and AAOIFI need not be necessarily be in the shape of legislative interventions, but in adopting the standards set out by the IFSB and AAOIFI as supplementary yet obligatory for the IFI, should ensure that the *sharia* governance issues are handled by the AAOIFI and/or the IFSB rather than local regulators who may be ill-equipped to carry out such functions. The role of the IFSB or the AAOIFI should also include the authority of revoking the ‘certificate’ in the case of an IFI, after repeated warnings and supervisory notes, failing to correct the *sharia* governance problem that was occurring. Whilst the certificate of compliance with *sharia* standards can be withdrawn by the IFSB and AAOIFI, the national regulator can still decide according to its own standards whether the financial institution still qualifies to function as a conventional financial institution or not. This way, both aspects of the regulation can be achieved without compromising the integrity of either system and at the same time strengthens the market for the operations of IFIs. It is thus argued that even though very limited national governmental intervention may still be necessary, it should be selective and carried out on a case-to-case basis for IFIs.

In case of the local regulator wanting to devise a separate regulatory framework (on the same lines as done in Pakistan, Malaysia and Iran) for the Islamic finance industry as a whole, they may be allowed to do so on the basis of the *sharia* compliance standards issued by the IFSB or the AAOIFI. It is also argued that since

any one single regulatory regime is seen to be insufficient to regulate Islamic finance across the broad spectrum of different jurisdictions; including the Civil law system, Common law system and the Islamic legal systems, smart regulatory practices would mean that a single ‘straight jacket’ regulatory framework would in any case be doomed to fail.

An example of a flexible regulatory measure meant to cater for the stakeholder nature of Islamic finance may be that when an IFI launches a new financial product, the IFI should disclose which Islamic jurisprudential school of thought they are adhering to. This way, rather than focusing on form, the instrument will be *sharia*-compliant whilst also ensuring full disclosure, thereby adhering to both good *sharia* governance principles and corporate governance best practices regarding transparency and disclosure. In further pursuance of this, the standard setting bodies like the IFSB and AAOIFI should clearly state that as long as the religious pronouncements (*fatwas*) regarding a particular product, transaction or practice are made in accordance with one of the schools of the thought and that information is declared, the instrument will be declared as *sharia*-compliant. Another benefit of this approach will be that the issue of *sharia* arbitrage is mitigated to a large extent, allowing the consumers to make an informed choice about the product they are choosing and which school of thought that product adheres to, so that if a consumer so wishes he may accept or reject it on the basis of their affinity to a particular school of thought. Utilising this approach means that the pressures for the local regulators of balancing national regulations and regulations pertaining to *sharia* are reduced, allowing for IFSB and AAOIFI to accept the responsibility of *sharia* compliance and at the same time allow the individual IFI to have some flexibility and keep a competitive edge in relation to product innovation.

f. The SSB and *Fatwas*

Another very important aspect that has caused some concern is the regulation and harmonisation of internal *sharia* compliance mechanisms like the SSB and religious pronouncements (*fatwas*). It is argued that these aspects should be the sole domain of the IFSB and the AAOIFI if the local legislature is not willing to make any amendments in its regulatory framework to accommodate them. Even where these amendments have been made (as is the case in jurisdictions like Pakistan, Malaysia and Iran), they should be made in consultation with the IFSB and AAOIFI, either by selecting such provisions that have already been published completely or selecting those which are in line with the national regulatory framework and leaving the rest to be dealt by the IFSB and AAOIFI. The other recommendation to mitigate this possible issue of the balance of power between the SSB and the executive board is to amend the articles of association (constitution) of the IFI to specify the exact ambit of powers for the SSB and also to specify the recourse to a particular dispute resolution method in case of a conflict of opinion between the SSB and the BOD. For example, recourse to a local or international arbitration body which specialises in Islamic finance rather than the local courts may be preferable because the local judiciary of a secular jurisdiction may not be well-versed at all with Islamic finance principles and practices. It follows that if the powers of both the BOD and the SSB are clearly set out, the chances of conflict per se are reduced.

Moreover, there must be better cooperation and coordination, particularly between and within governments and the financial and security regulatory authorities, so that there may be some uniformity in the regulatory environment in most jurisdictions where IFIs are working. Failure to do so will lead to *sharia* arbitrage and forum shopping by the individual IFI and may give way to a ‘race to the bottom’ consisting

of IFIs looking for the most relaxed regulatory environment. This could risk IFIs forgoing (deliberately or accidentally) the basic tenets of *sharia* principles regarding finance and business, which could turn out to be systemic and may lead to the loss in confidence across the globe in Islamic finance as a whole. This also has to be taken into consideration with the political context of the new world order; there is a lot more scepticism surrounding any and everything *sharia* (including but not limited to finance). This means that the industry has to focus on the regulatory aspects and concentrate all its energy in devising a framework that not only stabilises but also encourages public confidence in the industry.

g. Achieving the ‘public good’ through the meta-regulatory framework.

It is further argued that a ‘smart’ principle based meta-regulatory framework is the optimal way of achieving the ‘common good’ as a sub set of the normative ‘public good’(*Maslaha framework*) via financial intermediation of banks and other institutions.¹⁰⁴⁵ As previously discussed, a neoliberal profit-maximising approach is the antithesis of the public good argument with the popular slogan of ‘greed is good’.¹⁰⁴⁶ With the special emphasis of Islamic finance on achieving welfare for the whole of society, it has been argued that in normative as well as practical terms, the purpose of the Islamic economic system is the achievement of the public good(*Maslaha*) by ensuring a just and equitable distribution of wealth amongst the members of society. Further to this aim, the presence of a carefully devised meta-regulatory framework for IFIs which focuses on stakeholder practices and embodies business ethics is not only a requirement but is incontrovertible for both the practice, as well as the theory of, IFIs at both individual and industry level. Since the focus of

¹⁰⁴⁵ Argadona (n 479)

¹⁰⁴⁶ Friedman ‘The Social Responsibility Of Business’, 1970, New York Times Magazine, Sept 13th, 122-126

any meta-regulatory framework is to be able to identify a public interest goal and then devise regulatory measures aimed at achieving that public interest goal, it is argued that since the public aim of IFIs is to facilitate and act as intermediaries to ensure a just and equitable distribution of wealth in society(the *Maqasid al Sharia* of economic and financial activity), the emphasis of the standard-setting bodies ought to be fixated on the principles of Islamic finance as well as good corporate governance practices. This would ensure that all stakeholders are confident and feel safe and secure in using IFIs.

h. The normative mission statement of the IFIs

The aim of a regulatory framework for IFIs ought to be

‘to support social, ethical and economic development - providing the citizens, the depositors, the investors and other stakeholders who are directly and indirectly involved, with the protection and confidence they need to feel safe when dealing with the Islamic finance industry as being well structured, safe secure, sharia complaint, well governed and risk averse.’

For such a framework to be implemented alongside the *sharia* governance framework, special emphasis will also have to be placed on the internal corporate governance framework by the international standard-setting body, which should in turn be appropriately influenced by the stakeholder theory and its practice; focusing on the principles of honesty, integrity, property rights (as espoused by *sharia*), ethical trading, societal responsibility, stakeholder justice, employee participation, investor protection and transparency.

i. The BOD and the SSB: Altering the constitutional powers of Islamic financial institutions

It is also argued that adherence to the Islamic governance and regulatory standards should be made a part of the responsibility of the BOD in the IFI by virtue of them being the main executive body. It should be the responsibility of the BOD of the IFI to be in constant contact with the standard-setting bodies (the IFSB and the AAOIFI) to ensure compliance with the standards set out and the BOD should have a fiduciary obligation to the IAHs and the shareholders to ensure that all such measures are in place. This would make the IFI *sharia*-compliant as per the guidelines and standards laid down by the national regulators and the IFSB and/ or AAOIFI. As argued previously, whilst this extra duty of care to ensure *sharia* compliance would increase agency costs from a corporate governance point of view, the alternative of not adhering to these standards and practices may lead to the loss of confidence regarding the *sharia* compliance of the IFI by all the stakeholders including local regulators, the shareholders, employees and the IAHs. So whereas the initial adherence to these extra *sharia* standards may not seem cost effective, in the long term the IFI as a whole will be better off by doing so.

The other aspect that has been of concern is the issue of the status of the SSB in the management of the IFI. It is argued that, based on the foregoing discussion, when considering the unique nature of the IFI, there can be no exception to the issue of *sharia* compliance within the IFI. Thus, it is not only a matter of normative importance, but rather it is a fundamental aspect for a financial institution which wants to operate as an IFI that the SSB is given an authority over all the *sharia* aspects of the IFI. This may entail giving more powers to the SSBs. It has been asserted that the *sharia* compliance issues should be left to the IFSB and AAOIFI in

the proposed regulatory framework; this would mean that the BOD would be responsible for the overall running of the IFI but the SSB will be held exclusively responsible for the *sharia* compliance aspects of the IFI's operations.

It has to be emphasised, however, that the SSB will have executive powers only in matters pertaining to *sharia*, meaning that where there is a conflict of opinion between the BOD and the SSB, the SSB's opinion may only matter to the regulatory body that is concerned with handling Islamic finance Institutions and not to the local secular financial and securities regulators. The consequence of such a division of regulatory responsibilities will be that the IFI may still continue to operate as a normal conventional financial institution if it fails to abide by religious pronouncements (*fatwas*) of the SSB and the certificate of *sharia* compliance may be withdrawn, thereby revoking the IFI's sharia-compliant status. These issues can be highlighted in the AOA (articles of association) and MOA (memorandum of association) of the IFI at incorporation, so that there is a clear cut distinction of powers and responsibility.

j. Dispute resolution

It is also argued that any disputes that may arise regarding *sharia* compliance should be addressed to the IFSB, AAOIFI or any other such organisation which may have expertise in the resolution of *sharia* issues.¹⁰⁴⁷ It is therefore being argued that the IFSB and/or the AAOIFI should institute such dispute resolution methods in consultation with national regulators which would be deemed appropriate to the

¹⁰⁴⁷ Such as Dubai centre for arbitration and conciliation, the GCC commercial arbitration centre, the Bahrain centre for international commercial arbitration centre, the ICC's international chamber of commerce's international court of arbitration, the London court of international arbitration, the Kuwait centre for commercial arbitration, the Kualalampur arbitration centre. As quoted In Zulkifi Hasan (n 1006)

Islamic finance industry, especially where the local courts are not well-versed in *sharia* issues.

In case of a *sharia* issue being resolved in favour of the SSB, and the BOD is not content with the relevant solution, there will be two possibilities for them: the first will be to declassify as a *sharia*-compliant IFI and continue to operate as a conventional financial institution, and the second will be to accept the SSB's point of view. By virtue of this choice, the executive power of the BOD is not taken away and they may continue to run the IFI as a non-*sharia* body which would satisfy the national corporate laws. This may again seem strange to secular regulators, but as noted previously, the essence of an IFI has to be its *sharia* compliance and not its profit-making or operation purely for the sake of the investors (the shareholders). The central role of the SSB (or any other *sharia* supervisory body) cannot be undermined under any circumstances.

k. SSB qualifications: the regulatory response

This brings us to the important issue of *sharia* qualified persons suitable for modern day IFIs. It is argued that the SSB's members ought to be approved or acknowledged as *sharia* qualified by the IFSB or the AAOIFI before allowing them to undertake the task of issuing *fatwas* and sitting on the SSB. This will require a standardised testing process for the *sharia* qualifications and should be carried out en masse at least twice a year to ensure that only the right people are selected for the job. The standardised testing should be conducted in such a way that satisfies both conventional knowledge of banking and finance as well as *sharia* finance. This way, *sharia* qualified persons in Islamic finance will be able to better understand the modern day financial architecture and draw a synergy between Islamic finance and

conventional finance. In addition, the qualifying test should provide for all the different schools of thought in Islamic jurisprudence so that all aspects of Islamic finance are catered for and the best and the most qualified of the people are selected for the central role of the SSB members.

The extra costs of ensuring compliance with the requirements of standardised tests should be borne by the IFIs themselves, this cost will be moderated by the knowledge that such initial costs will go a long way in instituting a more professional and risk-averse approach in the long term. *Sharia* compliance - forming the major part of the operation of the IFI - has to be streamlined.

It is thus acknowledged that there has been a lot of work already undertaken in issuing *sharia* qualified scholar statuses across the globe: Malaysia, the UK, Bahrain and Pakistan have set examples of the kind of qualifications that should be acceptable. With many different bodies already issuing such a qualification,¹⁰⁴⁸ it is recommended that in the proposed regulatory framework, the IFSB and the AAOIFI may allow these local academic and licensing bodies to continue to do so and delegate some of their own powers to allow these private bodies to continue to issue these qualifications. In addition, to monitor their activities and set out detailed guidelines for the purpose of harmonising the tests or institute a new regime of standardised testing. These smaller and local bodies can issue ‘*sharia* qualified statuses’ in line with the central syllabi as laid down by the IFSB and the AAOIFI. It follows that the issue of SSB qualification and the competence of the members can

¹⁰⁴⁸ <http://www.ibfim.com/>, http://www.mifc.com/index.php?ch=ch_directory_talent&pg=pg_directory_talent_human&ac=107, <http://www.cimaglobal.com/Study-with-us/Islamic-finance-qualifications/>, <http://www.nottingham.edu.my/Study/Postgraduate-courses/Business/Investment-and-Islamic-Finance-MSc.aspx>, <http://www.inceif.org/academic-programmes/chartered-islamic-finance-professional/>, <http://www.amanaglobal.com/training/>, <https://www.dur.ac.uk/dcief/>, <http://www.islamic-banking.com/Default.aspx>, <http://www.nibaf.gov.pk/Pages/Islamic.htm>

be dealt with effectively at a regulatory level bringing the much needed harmonised testing standards.

3. Conclusion

The Islamic finance industry has come a long way in modern times and has made strides in almost all aspects of their operation. However, the regulatory pressure to abide by conventional governance and regulatory practices seems to be leading the industry to lose focus on the fundamental reason for its existence; to facilitate and promote socioeconomic justice in society for its adherents and all those who wish to participate in it. This is a fact that can be directly referred back to the main sources of *sharia*-based finance: the *Qur'an* and the *Hadith*. It is in reply to this mounting regulatory pressure that this thesis is suggesting a more internationally acceptable stakeholder-based meta-regulatory framework which balances out the diverse aspects of IFIs being both legal entities acceptable under conventional corporate governance theory as well as being a product of the fundamental norms of Islamic finance and economics literature. Nonetheless, they may not always be theoretically reconcilable, as discussed in detail in previous chapters on Islamic finance literature and conventional corporate governance literature. Accordingly, it is asserted that the policy recommendation given in this chapter is deemed to be suitable for the whole of the Islamic finance industry despite the jurisdictional differences between the different countries.

Overall, the introduction of new internal and external corporate governance structures, together with the reinforcement of existing ones, can provide stakeholders with sufficient comfort on the actions of management and other aspects of the financial institution. Internally, this requires procedures for the protection of

minority shareholders and provisions for increased disclosure, transparency, independence of the SSB and effective resolution of any possible conflicts between the executive management and the SSB. Further, concrete approaches to addressing the problems of commingling, UIA holders' rights and the utilisation of reserves would complete the internal corporate governance of the IFI and make the Islamic finance industry a robust financial alternative to conventional financial institutions.

For external factors, recognising the specificity of the IFI would lead to the stability of the industry and the protection of stakeholders. Regulators need to be flexible and to work with the Islamic financial institutions to fully understand the needs of the industry and thereby develop an appropriate regulatory framework. In addition, recourse to private self-regulatory initiatives may be more important in Islamic finance than in the conventional financial industry. In those countries where regulations present constraints on Islamic finance, IFIs need to evaluate the available options to determine which licensing status is best tailored to their needs and those of their stakeholders. Thus, the licensing issue may even lead to more systemic problems if the jurisdiction does not recognise *sharia*

It is therefore recognised that a lot of work has been done at national levels, but yet more may have to be undertaken by the international standard-setting bodies in respect of laying down more tailored requirements for the specific issues pertaining to: enforcement of Islamic contracts, designation of shareholders and IAHs as separate class of investors needing separate protections and standards of conduct, information disclosure, abiding by the societal aspects of their operations by declaring how that is being done even if the national regulation and laws do not require it as such, fulfilling auditing and accounting standards as laid down by the international standard setting bodies (though AAOIFI has been very proactive in this

regards) and ensuring enforcement of those standards as per local and IFSB and AAOIFI requirements. Thus, a meta-regulatory framework which is based on the basic principles of Islamic finance and oriented towards the stakeholder theory is the best solution for the aforementioned internal and external governance issues, including those issues pertaining to the lack of enforcement and compliance at an international level.

Bibliography

Abdelkader, D. (2003). Modernity, The Principles Of Public Welfare (Maslaha) And The End Goals Of Shari'a (Maqasid) In Muslim Legal Thought. *Islam And Christian-Muslim Relations*. 14 (2), Pp. 163-174.

Abdou, I. (1976) *Bunuk Bila-Fawa'id* (Banking Without Interest), Dar El-I'tissam, Cairo.

Ariff, Mohammad (Ed.): *Monetary An Financial Economics Of Islam*; International Centre For Research In Islamic Economics; Jeddah, Saudi Arabia, (1982).

Abdulrauf, M. (1979) *The Islamic Doctrine Of Economics And Contemporary Economic Thought*, American Enterprise Institution For Public Policy Research, Washington D.C.

Abu-Saud, M. (1980) "Money, Interest, And Qiradh" In A. Khurshid (Ed.) *Studies In Islamic Economics*, Islamic Foundation, Leicester.

Abu-Zahra, M. (1957) *El-Takaful El-Iitimae Fil-Islam* (Social Solidarity In Islam), Dar El-Fikr, Cairo.

Ackerman, B. A., Alstott, A. (1999). *The Stakeholder Society*, Yale University press, New Haven, Ct.

Adelman, I. And C. Morris (1967) *Society, Politics And Economic Development: A Quantitative Approach*, John Hopkins Press, Baltimore.

Afzalur-Rahman, M.A. (1974) *Economic Doctrines Of Islam*, Islamic Publication, Lahore.

Afzalur-Rahman, M.A. (1979) *Banking And Insurance. The Muslim School Trust*, London.

Afzalur-Rahman, M.A. (1982) "Muhammad", *Encyclopaedia Of Seerah*, Vol.2. The Muslim School Trust, London.

Afzalur-Rahman, M.A. (1980) *Islam Ideology And The Way Of Life. The Muslim School Trust*, London.

Aguilera, R. V., Rupp, D. E., Williams, C. A., And Ganapathi, J. (2007). Putting The S Back In Corporate Social Responsibility: A Multilevel Theory Of Social Change In Organizations. *The Academy Of Management Review*, 32(3): 836 – 863.

Aguilera, R. V., Williams, C. A., Conley, J. M. And Rupp, D. E. (2006). Corporate Governance And Social Responsibility: A Comparative Analysis Of The Uk And The Us. *Corporate Governance: An International Review* 14 (3), 147-158.

- Abbadi, A. S. (1977) *Al-Mal4ah Fai Al-Sharia Al-Islamiah*, Maktabah Al-Aqsa, Vol. 3, Amman.
- Abdel-Haq, M. K. (1991) 'Islamic Development Bank' *American Journal Of Islamic Finance*, Vol. II, No. 3.
- Abdel-Haq, M. K. (1989) 'Islamic Development Bank: An Analytical Study.' M.A. Thesis, Yarmouk University.
- Abdel-Haq, Y. (1979) *Planning And Development In Jordan*. Ain Shams University, Cairo.
- Abdel Kader, D. 'Modernity, The Principles Of Public Welfare (Maslaha) And The End Goals Of Shari'a (Maqasid) In Muslim Legal Thought,' (2003). *Islam And Christian-Muslim Relations*. 14 (2), Pp. 163-174.
- Abdul-Jabir, T. (1987) 'Comments On Problems Of Research In Islamic Economics'. A Symposium Jointly Held By The Islamic Research And Training Institute, Islamic Development Bank And The Royal Academy For Islamic Civilization Research, Amman.
- Abu-Zahra, M. 'El-Takaful El-Iitimae Fil-Islam (Social Solidarity In Islam),' (1957), Dar El-Fikr, Cairo.
- Ackerman, B. A., Alstott, A 'The Stakeholder Society,' (1999). Yale University Press, New Haven, CT.
- Adam Smith, 'An Inquiry Into The Nature And Causes Of The Wealth Of Nations,' Book IV, Ch 2, Pg 423, (Mod .Lib. Ed 1937)
- Ahmad, A. (1987a) *Development And Problems Of Islamic Banks*. Islamic Research And Training Institute, Islamic Development Bank, Jeddah.
- Agu, C.C. (1984) *Banking Structure And Performance: A Study Of The Nigerian Banking System And Its Contribution To Nigeria's Economic Development 1960-1980*, Ph.D. Thesis, Ucnw, Bangor.
- Ahmad, K. (1994). *Elimination Of Riba: Concept And Problems*, In. K. Ahmad, *Elimination Of Riba From The Economy*, Institute Of Policy Studies, Islamabad. Pp. Pp. 33-63.
- Ahmed, S.M. 'Social Justice In Islam', Ahmed, S.M. (1975) *Institute Of Islamic Culture Lahore*. Ashraf Publications, Lahore.
- Accounting, Auditing, And Governance Standards For Islamic Financial Institutions*, 1420H-1999, Bahrain: AAOIFI
- Accounting, Auditing, And Governance Standards For Islamic Financial Institutions*, 1421H-2000, Bahrain: AAOIFI

- Alam, K. Firoz, (1991), Shariah, Financial Dealings And Accounting Practices, South East Asia University Accounting Teachers Conference, Pp. 552-562
- Alexander, D., (May 1993), A European True And Fair View? The European Accounting Review, Vol. 2 No 1, Pp. 59-80
- Alexander, D., (June 1998), "True And Fair: The European Perspective", Accountancy, P. 92
- Alexander, D. And Archer, S. (1998a), On The True And Fair View In Financial Reporting: A Philosophical Analysis And Critique, Paper Presented At The European Accounting Association Annual Congress, Antwerp, April 1999.
- Alexander, D. And Archer, S., (2000), On The Myth Of "Anglo-Saxon" Financial Accounting, International Journal Of Accounting, Vol. 35, No. 4, Pp. 539-557
- Alreck, Pamela L., And Settle, Robert B., (1995), The Survey Research Handbook, 2nd Edition, USA: Irwin.
- Al-Sadah, A., (1999), Regulation Of Financial Reporting By Islamic Banks, Unpublished Mphil Thesis, University Of Surrey, Guildford, UK
- Al-'Alwani, T. J. And El-Ansary, W. A., Linking Ethics And Economics: The Role Of Ijtihad In The Regulation And Correction Of Capital Markets. Centre For Muslim-Christian Understanding: History And International Affairs, Georgetown University. Virginia. (1999)
- Alhabshi, S. 'The Role Of Ethics In Economics And Business.' 0. (1987). Journal Of Islamic Economics. 1 (1), Pp. 1-15.
- Al-Omar, F. And Abdel-Haq, M. 'Islamic Banking: Theory, Practice And Challenges'. (1996). London & New Jersey, Zed Books
- Arabi. O 'Contract Stipulations (Shurut) In Islamic Law: The Ottoman Majalla And Ibn Taymiyya', (1998)
- Archer, S., (1996), The Ethics Of Creative Accounting, Science And Engineering Ethics, Vol. 2 No. 1
- Archer, S., And Karim, R. A. A., (1997), Agency Theory, Corporate Governance, And The Accounting Regulation Of Islamic Banks, Research In Accounting Regulation, Supplement 1, PP. 97-114
- Archer, S., Karim, R. A. A., And Al-Deehani, T., (1998), Financial Contracting, Governance Structures And The Accounting Regulation Of Islamic Banks: An Analysis In Terms Of Agency Theory And Transaction Cost Economics, Journal Of Management And Governance, Pp. 149- 170
- Ariff, M., (September 1988), Islamic Banking, Asian-Pacific Economic Literature, Vol. 2, No. 2, Pp. 48-64

- Arrow, K.J., 'Individual Choice Under Certainty And Uncertainty.' 1984. Cambridge, Ma: Belknap Press.
- Ahmad, K. (2000). Islamic Finance And Banking: The Challenge And Prospects. *Review Of Islamic Economics*. 9, Pp. 57-82.
- Ahmad, K. (2002). Islamic Ethics In A Changing Environment For Managers, In. A. M. Sadeq, *Ethics In Business And Management: Islamic And Mainsream Approaches*, Asean Academic Press, London. Pp. 97-109.
- Alchian, A. (1965). The Basis Of Some Recent Advances In The Theory Of Management. *Journal Of Industrial Economics* 14,30-41.
- Alchian, A. And H. Demsetz (1972). Production, Information Costs, And Economics Organisation. *American Economics Review* 62,777-795.
- Al-'Alwani, T. J. And El-Ansary, W. A. (1999). *Linking Ethics And Economics: The Role Of Ijtihad In The Regulation And Correction Of Capital Markets*. Centre For Muslim-Christian Understanding: History And International Affairs, Georgetown University. Virginia.
- Alhabshi, S. O. (1987). The Role Of Ethics In Economics And Business. *Journal Of Islamic Economics*. 1 (1), Pp. 1-15.
- Al-Omar, F. And Abdel-Haq, M. (1996). *Islamic Banking: Theory, Practice And Challenges*. London & New Jersey, Zed Books.
- Ahmed, S.M. (1952) *Economics Of Islam*, Ashraf Publications, Lahore .Ahmed, S.M. (1975) *Social Justice In Islam*, Institute Of Islamic Culture Lahore.
- Amaeshi, K., And Adi, B. C. (2007). Reconstructing Corporate Social Responsibility, *Business Ethics European Review* 16(1): 3-18.
- Andriof, J. And Waddock, S. (2002). *Unfolding Stakeholder Engagement*. In: J.Andriof Et Al. (Eds.). *Unfolding Stakeholder Thinking - Theory, Responsibility And Engagement*. Sheffield: Greenleaf Publishing
- Anells, M. (1996). Grounded Theory Methodology: Philosophical Perspectives, Paradigm Of Inquiry, And Postmodernism. *Qualitative Health Research* 6,379-393.
- Andriof, J., Husted, B., Waddock, S. And Rahman, S. S. (2002). Introduction. In Andriof, J., Waddock, S., Husted, B. And Rahman, S. S. (Eds.), *Unfolding Stakeholder Thinking: Theory, Responsibility And Engagement*: 9-16.Sheffield: Greenleaf.
- Andrea Beltratti, 'The Complementarity Between Corporate Governance And Corporate Social Responsibility,' Bocconi University, The Geneva Papers 2005,30, (373-386) December 2005)

Ansari, A. H. (1989). Islamic Ethics: Concept And Prospect. The American Journal Of Islamic Social Sciences. 6 (1), Pp. 81-91.

Assem Safieddine, 'Islamic Financial Institutions And Corporate Governance: New Insights For Agency Theory,' Corporate Governance: An International Review, 2009, 17(2): 142–158

Argandona, A. (1998). The Stakeholder Theory And The Common Good. Journal Of Business Ethics. 17, Pp. 1093-1102.

Archer, S., And Abid, N., (2000), International Accounting Regulations For Islamic Banks, In Anthology Of Islamic Banking, London: Iibi, Pp. 415-420

Azmi, S. H. (1991). Traditional Islamic Social Welfare: Its Meaning, History And Contemporary Relevance. Part I-iii. Islamic Quarterly. Xxxv And Xxxvi (3,4 And 1)

Abu Ameenah Philips 'The Evolution Of Fiqh,' 2006. International Islamic Publishing House, Riyadh. Saudi Arabia

Abu Dawud (1990). Sunan Abu Dawud, Trans. By Ahmad Hasan, Vol. I-III. New Delhi: Kitab Bhaban.

Al-Qaradawi, Yusuf (N.D.). The Lawful And The Prohibited In Islam. New Delhi: Hindustan Publications.

Ali, Engku Rabiah Adawiya Engku (N.D.). Riba And Prohibition In Islam. International Islamic University, Malaysia, Available At: <URL: [Http://Www.Cert.Com.My/Cert/Pdf/RIBA_AN2. PDF](http://Www.Cert.Com.My/Cert/Pdf/RIBA_AN2.PDF), Access Date: 3rd June 2008.

Badawi, Zaki Al-Din. (2008). Theory Of Prohibited Riba. Trans. By Imran Ahsan Khan Nyazee, Available At: <URL: [Http://Www.Nyazee.Org/Islbanks/Riba/Riba.Html](http://Www.Nyazee.Org/Islbanks/Riba/Riba.Html)>, Access Date: 7th June 2008.

Badawi, Z., (December 1996-January 1997), Ijtihad In Islamic Financial Management: Mapping The Way To Consensus, Islamic Banker, No. 12, Pp.2 0-21

Baiman, S. (1982). Agency Research In Managerial Accounting: A Survey. Journal Of Accounting Literature, 154-213.

Barney, J. (1991). Firm Resources And Sustained Competitive Advantage. Journal Of Management 17,99-120.

Barzel, Y. (1987, January). The Entrepreneur's Reward For Self-Policing. Economic Enquirt' 25,103-116.

Baumol, W. (1959). Business Behaviour, Value And Growth. Macmillan, London.

Barnett, M. L. (2007). Stakeholder Influence Capacity And The Variability Of Financial Returns To Corporate Social Responsibility. *Academy Of Management Review*, 32(3): 794-816

Bala Shanmugam And Vignesen Perumai, 'Governance Issues And Islamic Banking' *Hedge Fund Monthly*, Singapore, December 2006, Pp 1-4

Bebchuk, Lucian A., Cohen, Alma And Ferrell, Allen 'What Matters In Corporate Governance?' (September 1, 2004). *Review Of Financial Studies*, Vol. 22, No. 2, Pp. 783-827, February 2009; Harvard Law School John M. Olin Center Discussion Paper No. 491 (2004). Available At SSRN: [Http://Ssrn.Com/Abstract=593423](http://Ssrn.Com/Abstract=593423) Or Doi:10.2139/Ssrn.593423

Beekun, R. I. (1996). *Islamic Business Ethics*. Herndon, Usa, The International Institute Of Islamic Thought.

Berman, S. L., Wicks, A. C., Kotha, S. And Jones, T. M. (1999). Does Stakeholder Orientation Matter? The Relationship Between Stakeholder Management Model And Firm Financial Performance. *Academy Of Management Journal*. 42 (5), Pp. 488-506.

Berle, A. A. And Means, G. C. (1932). *The Modern Corporation And Private Property*. New York, Macmillan Publishing Co.

Berman, S., Wicks, A., Kotha, S., And Jones, T. (1999). Does Stakeholder Orientation Matter? The Relationship Between Stakeholder Management Models And Firm Financial Performance. *Academy Of Management Journal*, 42(5): 488-506.

Biraima, M., (December 1996), A Quranic View Of Social Reality And Its Implications For A Universal Social Science: The Case Of Economics, *Proceedings Of The Second International Conference On Islamic Political Economy*, Usm.

Blair, M. (1995). *Ownership And Control Rethinking Corporate Governance For The Twenty-First Century*. The Brookings Institute Washington, D. C.

Bryman, A. (1984). Organisational Studies And The Concept Of Rationality. *Journal Of Management Studies* 21 (1), 391-408.

Bo Enquist, Mikael Johnson, Per Skålen, "Adoption Of Corporate Social Responsibility – Incorporating A Stakeholder Perspective", (2006) , *Qualitative Research In Accounting & Management*, Vol. 3 Iss: 3, Pp.188 - 207

Boatright, J. R. (1993). *Ethics And The Conduct Of Business*. New Jersey, Prentice Hall.

Bowie, N. (1991). New Directions In Corporate Social Responsibility. *Business Horizons*. 34, Pp. 56-65.

Bowie, N. E., And Freeman, R. E. (Eds.), (1992), *Ethics And Agency Theory: An Introduction*, New York: Oxford University Press.

Bowie, N. (1998). A Kantian Theory Of Capitalism. *Business Ethics Quarterly*, The Ruffin Series, Special Issue No. 1: 37-60.

Boyer, R. (2005). How And Why Capitalisms Differ. *Economy And Society*, 34(4): 509-57.

Berman, S., Wicks, A., Kotha, S., And Jones, T. 'Does Stakeholder Orientation Matter? The Relationship Between Stakeholder Management Models And Firm Financial Performance.' (1999). *Academy Of Management Journal*, 42(5): 488-506

Blair, M 'Ownership And Control Rethinking Corporate Governance For The Twenty-First Century.' (1995). The Brookings Institute Washington, D. C

Bradley R.Agle, Thomas Donaldson, R.Edward Freeman, Michael C.Jensen, Ronald K.Mitchell And Donna J. Wood, 'Dailogue: Towards Superior Stakeholder Theory.' *Business Ethics Quarterly*, Vol 18, Issue 2, Pp 153-190. 2008

Bruce, L., (October 1994), Stakeholders And The Moral Responsibilities Of Business, *The Journal Of The Society For Business Ethics*, Vol. 4, No. 4, Pp. 431-444.

Cadbury, A. (1992). *The Report Of The Committee On Financial Aspects Of Corporate Governance*. Gee And Co, London.

Carroll, A. B, (1993), *Business And Society: Ethics And Stakeholder Management*, Cincinnati, Oh: South-Western.

Carroll, A. B. (1991). The Pyramid Of Corporate Social Responsibility: Toward The Moral Management Of Organizational Stakeholders. *Business Horizons*, 34(4): 39-48.

Carroll, A. B. (1999). Corporate Social Responsibility: Evolution Of A Definitional Construct. *Business & Society*, 38(3): 268-295.

Carroll, A. B. (2004). Managing Ethically With Global Stakeholders: A Present And Future Challenge. *Academy Of Management Executive*, 18(2): 114-119.

Charkham, J. (1994a). *Keeping Good Company: A Study Of Corporate Governance In Five Countries*. Clarendon Press, Oxford.

Charkham, J. (1994b). *Larger Role For Institutional Investors*. Clarendon Press, Oxford. UK.

Cheung, S. (1983). The Contractual Nature Of The Firm. *Journal Of Law And Economics* 26, 403-411.

Clarkson, M. B. E. 'A Stakeholder Framework for Analysing And Evaluating Corporate Social Performance.' (1995). *Academy Of Management Review* 20: 92 - 117.

Crane, A., Matten, D., And Moon, J. 'Stakeholders As Citizens? Rethinking Rights, Participation, And Democracy.' (2004). *Journal Of Business Ethics* 5, 3(1-21):0 7-122.

Coase, R. (1937). The Nature Of The Firm. *Economica* 4,386-405.

Cohen, M., J. March, And P. Olsen (1972). A Garbage Can Model Of Organizational Choice. *Administrative Science Quarterly* 17(1), 1-25.

Collis, J. And R. Hussey (2003). *Business Research* (2 Ed.). Palgrave Macmillan, London.

Collier, Jane And Roberts, 'Introduction: An Ethic For Corporate Governance?', *Business Ethics Quarterly* 11, 2001, 1:67-71.

Conner, K. And C. Prahalad (1996). A Resource-Based Theory Of The Firm: Knowledge Versus Opportunism. *Organization Science* 7,477-501.

Canyon, M. And P. Gregg (1994). Pay At The Top: A Study Of The Sensitivity Of Top Director Remuneration To Company Specific Shocks. *National Institute Economic Review* 149, 88-92.

Canyon, M. And D. Leech (1994). Top Pay, Company Performance And Corporate Governance. *Oxford Bulletin Of Economics And Statistics* 56,229-247.

Canyon, M. And Nicolitsas (1998). Does The Market For Top Executives Work? Ceo Pay And Turnover In Small Uk Companies. *Small Business Economics* 11,145-154.

Cosh, A. And A. Hughes (1987). The Anatomy Of Corporate Control: Directors, Shareholders And Executive Remuneration In Giant US And UK Corporations. *Cambridge Journal Of Economics* 11(4), 285-313.

Collier, J. 'Theorizing The Ethical Organization.' (1998). *Business Ethics Quarterly*, 8(4): 621-654.

Conner, K. And C. Prahalad 'A Resource-Based Theory Of The Firm: Knowledge Versus Opportunism.' (1996). *Organization Science* 7,477-501.

Carroll, A. B. (1979). A Three Dimensional Conceptual Model Of Corporate Social Performance. *Academy Of Management Review*, 4: 497-505.

Corporate Governance: A Framework For Implementation', World Bank (2000). Washington: World Bank.

Clarkson, M. B. E. (1995). A Stakeholder Framework For Analyzing And Evaluating Corporate Social Performance. *Academy Of Management Review* 20: 92-117.

Charkham, J., (1994), *Keeping Good Company: A Study Of Corporate Governance In Five Countries*, New York: Oxford University Press Inc.

Charles A. Ravich: 'Islamic Finance; Pancea For The Global Financial System?'
[Http://Ssrn.Com/Abstract=1483789](http://ssrn.com/abstract=1483789).

Chapra, M. U. (1985). *Towards A Just Monetary System*. Leicester, The Islamic Foundation.

Chapra, M. U. (1987). *Towards An Islamic Financial System*, In *International Seminar On Islamic Economics*, International Islamic University Malaysia. Kuala Lumpur.

Chapra, M. U. (1992). *Islam And The Economic Challenge*. Leicester, The Islamic Foundation.

Chapra, M. U. (2000a). *The Future Of Economics: An Islamic Perspective*. Leicester, The Islamic Foundation.

Chapra, M. U. (2000b). Why Has Islam Prohibited Interest: Rationale Behind The Prohibition Of Interest. *Review Of Islamic Economics*. 9, Pp. 5-20.

Chapra, M. U. And Ahmed, H. (2002). *Corporate Governance In Islamic Financial Institutions*. Islamic Development Bank And Islamic Research And Training Institute. Jeddah.

Chapra, M. U. And Khan, T. (2000). *Regulation And Supen'ision Of Islamic Banks*. Jeddah, Islamic Development Bank And Islamic Research And Training Institute.

Chapra, U. And Ahmed, H. (2002). *Corporate Governance In Islamic Financial Institutions*. Occasional Paper No. 6. Jeddah, Irti, Islamic Development

Cheung, S. 'The Contractual Nature Of The Firm.' (1983). *Journal Of Law And Economics* 26, 403-411.

Coase, R. 'The Nature Of The Firm.' (1937). *Economica* 4, 386-405.

Collier, J. (1998). Theorising The Ethical Organization. *Business Ethics Quarterly*, 8(4): 621-654.

Crane, A., Matten, D., And Moon, J. (2004). Stakeholders As Citizens? Rethinking Rights, Participation, And Democracy. *Journal Of Business Ethics* 5, 3(1-21):0 7-122.

Cyert, R. And J. March 'A Behavioural Theory Of The Firm.' (1963). Prentice Hall, New York.

Dar, H. And Presley, J. (2000). Lack Of Profit Loss Sharing In Islamic Banking: Management And Control Imbalances. International Journal Of Islamic Financial Sciences. 2 (2)

Dar, H., Presley, J. And Harvey, D. (1999). Size, Profitability And Agency Problem In Profit And Loss Sharing In Islamic Finance. Economic Research Paper. (No. 98/13).

D.V. Abdullah And K. Chee, 'Islamic Finance Why It Makes Sense, Understanding Its Principles And Practices', Marshall Cavendish International. 2010.

Davies, P. W. F. (1997). Business Philosophy: Searching For An Authentic Role, In. P. W. F. Davies, Current Issues In Business Ethics, Routledge, London.

Davies, R. (2003). The Business Community: Social Responsibility And Corporate Values, In. J. H. Dunning, Making Globalization Good: The Moral Challenge Of Global Capitalism, Oxford University Press, Oxford.

Dawkins, J. And Lewis, S. (2003). Csr In Stakeholder Expectations: And Their Implication For Company Strategy. Journal Of Business Ethics. 44 (2), Pp. 185-193.

Davis, K., 'The Case For And Against Business Assumption Of Social Responsibilities.' (1973). Academy Of Management Journal, 16/2, Pp 313

Davies, P. W. F. (Ed.), (1997), Current Issues In Business Ethics, London: Routledge. Demsetz, H. (1988). The Theory Of The Firm Revisited. Journal Of Law, Economics And Organization 4, 141-162.

Demsetz, H. And B. Villalonga (2001). Ownership Structure And Corporate Performance. Journal Of Corporate Finance 7(3), 209-233.

Demsetz, H. 'The Theory Of The Firm Revisited.' (1988). Journal Of Law, Economics And Organization 4, 141-162.

Deeg, R., Jackson, G. (2007): The State Of The Art: Towards A More Dynamic Theory Of Capitalist Variety, Socio-Economic Review, 5, 149-179".

Dill, W., 'Public Participation In Corporate Planning: Strategic Management In A Kibitzer's World, 1975. Long Range Planning 8(1): 57-63.

Domènec Melé And Manuel Guillén, 'The Intellectual Evolution Of Strategic Management And Its Relationship With Ethics And Social Responsibility' Working Paper Wp No 658 October 2006, Electronic Copy Of This Paper Is Available At: [Http://ssrn.com/abstract=960663](http://ssrn.com/abstract=960663)

Donaldson, T , *Corporation And Morality* (Prentice-Hall 1982)

Donaldson, T., & Dunfee, T. W. (1994). Toward A Unified Conception Of Business Ethics: Integrative Social Contracts Theory. *Academy Of Management Review*, 19: 252-284.

Donaldson, T., & Preston, L. E. (1995). The Stakeholder Theory Of The Corporation: Concepts, Evidence And Implications. *Academy Of Management Review*, 20: 65-91.

Donaldson, T. (1999). Making Stakeholder Theory Whole. *Academy Of Management Review*. 24 (2), Pp. 237-241.

Douglas M. Branson, ‘ Corporate Governance "Reform" And The New Corporate Social Responsibility’, *University Of Piitsburgh Law Review* [Vol. 62:605].

Eaton, G ‘Islam And The Destiny Of Man.’.: 1994, (The Islamic Texts Society, Cambridge)

E. Colon And J.Parks ‘The Effects Of Monitoring And Tradition On Compensation Arrangements: An Experiment On Principal/Agent Dyads. 1988)

Etzioni, A. ‘The New Golden Rule. Community And Morality In A Democratic Society.’ (1996), New York: Basic Books

Etzioni, A ‘ A Communitarian Note On Stakeholder Theory’, (1998).*Business Ethics Quarterly*, 8/4:679-91.

Evan, W., And Freeman, R. E. (1988). A Stakeholder Theory Of The Modern Corporation: Kantian Capitalism. In T. Beauchamp & N. Bowie (Eds.), *Ethical Theory And Business*: 75-93. Englewood Cliffs, Nj: Prentice-Hall.

El-Gamal, Mahmoud (2000). “An Economic Explication Of The Prohibition Of Riba In Classical Islamic Jurisprudence’, In *Proceedings Of The Third Harvard University Forum On Islamic Finance*, Cambridge: Centre For Middle Eastern Studies, Harvard University, Pp. 31-44, Available At: <URL: [Http://Www.Ruf.Rice.Edu/~Elgamal/Files/Riba.Pdf](http://Www.Ruf.Rice.Edu/~Elgamal/Files/Riba.Pdf)> , Access Date: 3rd June, 2008.

Elaine Stenberg ‘Just Business: Business Ethics In Action.’1994. London : Little, Brown And Co.

Fadel, Mohammad (2008). “Riba, Efficiency And Prudential Regulation: Preliminary Thoughts”, *Wisconsin International Law Journal*, 25 (4), Pp. 655-702.

Farooq, Mohammad Omar (2007b). Exploitation, Profit And The Riba-Interest Reductionism. Paper Presented At The Annual Conference Of Eastern Economic Association (EEA), New York, February 23-26.

Farooq, Mohammad Omar (2007c). "Stipulation Of Excess In Understanding And Misunderstanding Riba: The Al-Jassas Link", Arab Law Quarterly, 21 (4), Pp. 285-316.

Farooq, Mohammad Omar (2008a). Qard Hasan, Wadiah/Amanah And Bank Deposits: Applications And Misapplications Of Some Concepts In Islamic Banking. Paper Presented At The Eight Harvard Islamic Finance Forum, Cambridge, M.A., April 19-20, 2008. 140 Review Of Islamic Economics, Vol. 13, No. 1, 2009

Farooq, Mohammad Omar. (2007a). "The Riba-Interest Equivalence: Is There An Ijma (Consensus)?" Transnational Dispute Management, 4(5), Available At: <URL: [Http://Www.Transnational-Dispute-Management.Com/Members/Articles/Welcome.Asp?Key =1063&N_Key=20](http://www.transnational-dispute-management.com/members/articles/welcome.asp?key=1063&n_key=20)>, Access Date: 3rd June 2008.

Farooq, Mohammad Omar. (2008b, Forthcoming). Toward Our Reformation: From Legalism To Value-Oriented Islamic Law And Jurisprudence. Herndon, Virginia: International Institute Of Islamic Thought.

Fannon, L. I. (2003) Working Within Two Kinds Of Capitalism: Corporate Governance And Employee Stake Holding: Us And Eu Perspectives, Oxford-Portland, Or: Hart Publishing.

Fama, E. (1980). Agency Problems And The Theory Of The Firm. Journal Of Political Economy 88,288-307.

Fama, E. And M. C. Jensen (1983). Separation Of Ownership And Control. Journal Of Law And Economics 26,301-326.

F. Pryor "The Islamic Economic System", Journal Of Comparative Economics, Vol.9, 1985, Pp.197-223

Francis, Taylor "What Is Socialism?" . Journal Of Socialist Theory 40 (2013): 27
Freeman, R. E. (1984). Strategic Management: A Stakeholder Approach. Boston: Pitman.

Freeman, R. E. (1994). The Politics Of Stakeholder Theory: Some Future Directions. Business Ethics Quarterly 4(4): 409 – 421.

Freeman. R.E And Reed,D.L 'Stockholders And Stakeholders: A New Perspective On Corporate Governance', (1983), California Management Review, 25/3:88-106

Freeman, R. E. And Mcvea, J. (2001). A Stakeholder Approach To Strategic Management. In M. Hitt, E. Freeman And J. Harrison (Eds) The Blackwell Handbook Of Strategic Management. Oxford: Oxford University Press.

Freeman, R. E., And Evan, W. M. (1990). Corporate Governance: A Stakeholder Interpretation. The Journal Of Behavioural Economics1, 9(4):3 37-359.

Friedman, A. L. And Miles, S. (2006). Stakeholders: Theory And Practice, Oxford: Oxford University Press.

Friedman, M. (1967). Capitalism And Freedom. Chicago Il, University Of Chicago Press.

Friedman 'The Social Responsibility Of Business', 1970, New York Times Magazine, Sept 13th,Pg 122-126.

Fuad Al-Omar And Muhammed Abdel-Haq 'Islamic Banking, Theory, Practice And Challenges.', 1996, Oxford University Press, Karachi, Pakistan

Galbraith, J. K.: 'The Affluent Society.' 1958, (Houghton Mifflin, Boston, MA).

Gibson, K. (2000). The Moral Basis Of Stakeholder Theory. Journal Of Business Ethics. 26, Pp. 245-257.

Goodpaster, K. E. (1983). The Concept Of Corporate Responsibility. Journal Of Business Ethics, 2(1): 1-22.

Goldberger, A. (1964). Econometric Theory. Macmillan New York.

Grant, R. M. (1996). Toward A Knowledge-Based Theory Of The Firm. Strategic Management Journal 17,109-122.

Gray, R.H, Owen,D.L And Adams, 'Accounting And Accountability: Changes And Challenges In Corporate Social And Environmental Reporting.' (1996). Hemel Hempstead, Uk: Prentice-Hall

Grayson, David And Adrian Hodges, Everybody's Business: Making Risks And Opportunities In Today's Global Society. 2001. London: Dorling Kindersley Ltd.

Geoffrey Heal, 'Corporate Social Responsibility. An Economic And Financial Framework,' Columbia Business School December 2004.

G.J(Deon) Rossow And Alejo Jose G.Sison, 'Global Perspectives On Ethics Of Corporate Governance,' (Editors);Palgrave Macmilan, 2006

Ghazi, M., (February 1999), Contemporary Corporate Finance: Modaraba Financing, An Appraisal. New Horizon, No. 84, Pp-3-7.

Ghoshal, S. And P. Moran 'Bad For Practice: A Critique Of The Transaction Cost Theory.' (1996).The Academy Of Management Review 21,13-47.

Gibson, K. 'The Moral Basis Of Stakeholder Theory.' (2000). *Journal Of Business Ethics*. 26, Pp. 245-257.

Gulati, R., Nohria, N., And Zaheer, A. (2000). *Strategic Networks*, *Strategic Management Journal*, 21(3): 203-215.

Hart, O. And J. Moore (1990). *Property Rights And The Nature Of The Firm*. *Journal Of Political Economy* 98(6), 1119-1158.

Hanafy, A. A. And H. Sallam 'Business Ethics: An Islamic Perspective', 1988, *Proceedings Of The Seminar On Islamic Principles Of Organizational Behaviour* (International Institute Of Islamic Thought, Herndon, VA).

Hancke, B., Rhodes, M., And Thatcher, M. (2007). *Introduction: Beyond Varieties Of Capitalism*. In: B. Hancke, M. Rhodes And M. Thatcher (Eds.), *Beyond Varieties Of Capitalism: Conflict, Contradictions, And Complementarities In The European Economy*. Oxford: Oxford University Press.

Haneef, M. A. M. (1997). *Islam, The Islamic Worldview, And Islamic Economics*. *Hum Journal Of Economics And Management*. 5 (1), Pp. 39-65.

Hanafy A. A 'Employee And Employer: Islamic Perception',.: 1988, *Proceedings Of The Seminar On Islamic Principles Of Organizational Behaviour* (International Institute Of Islamic Thought, Herndon, VA)

Haron, S. (1995). 'The Philosophy And Objective Of Islamic Banking: Revisited'. *New Horizon*.

Haron, S. (1999). *Islamic Banking: Rules And Regulations*. Kuala Lumpur, Pelanduk Publications.

Haron, S. (2000a). *The Philosophy Of Islamic Banking*, In. A. Siddiqi, *Anthology Of Islamic Banking*, Institute Of Islamic Banking And Insurance, London. Pp. 55-58.

Haron, S. And Shanmugam, B. (2001). *Islamic Banking System: Concepts And Applications*. Kuala Lumpur, Pelanduk Publications.

Harrison, J. G. & Freeman, R. E. (1999). *Stakeholders, Social Responsibility, And Performance: Empirical Evidence And Theoretical Perspectives*. *Academy Of Management Journal* 42(5): 479 – 485.

Haron, S. And Shanmugam, B 'Islamic Banking System: Concepts And Applications'. Kuala Lumpur, Pelanduk Publications. 2010

Hart, O. And J. Moore 'Property Rights And The Nature Of The Firm.' (1990). *Journal Of Political Economy* 98(6), 1119-1158

Hassan H 'Contracts Of Islamic Law: The Principles Of Commutative Justice And Liberty', , *Journal Of Islamic Studies* (2002)

Hill, C. W. L., And Jones, T. M. (1992). Stakeholder-Agency Theory. *Journal Of Management Studies*, 29: 131-154.

Hisham M. Ramadan 'Understanding Islamic Law: From Classical To Contemporary,' Ed., 2006, Pg 31. Lanham, Md And New York: Altamira Press

Hutton, W. 'The State We're In.' (1995). Johnathan Cape, London

I.A.I.B. (1990) International Association Of Islamic Banks. *Directory Of The Islamic Banks And Financial Institutions, Members Of The Association.*

I.A.I.B. (N.D.) The International Association Of Islamic Banks. 100 Questions And 100 Answers On Islamic Banks. Translated By Faisal Abdel Latif And Husam Ezzeddin.

I.D.B. (1981a) 'Articles Of Agreement'.

I.D.B. (1981b) 'Rules And Regulations Of The Bank'.

I.D.B. (1981c) 'Operation Manual'.

Ismail, A. H. (1992) 'Bank Islam Malaysia Berhad: Principles And Operations', In *An Introduction To Islamic Finance*, Sheikh G. Sheikh A., S. O. S. Ayil And A. Hj. Ghazali (Eds.). Quill Publishers, Kuala Lumpur.

Iqbal, Z. And A. Mirakhor (1987) 'Islamic Banking', Occasional Paper 49. International Monetary Fund, Washington D.C., USA.

Irshad, "Economic System For Interest Free Islamic Society" In: *Some Economic Aspects Of Islam*, World Muslim Congress (Ed.), Karachi 1964, P. 59.

Iqbal, M. And Molyneux, P. (2005). *Thirty Years Of Islamic Banking: History, Performance And Prospects*. New York, Palgrave Macmillan.

Ibn Majah (1995). *Sunan Ibn Majah*. (Translated By Muhammad T. Ansari). Islamabad: Kazi Publications.

Imam Bukhari (N.D.). *Sahih Al-Bukhari*. (Translated By Muhammad Muhsin Khan). Madinah.

Imam Malik (1985). *Muwatta' Imam Malik*. (Translated By M. Rahimuddin). Lahore: Sh. Muhammad Ashraf.

Imam Muslim (1982), *Sahih Muslim*. (Translated By Abdul Hamid Siddiqi). Lahore: Sh. Muhammad Ashraf, Vol. III.

Iqbal, Muhammad Mazhar (N.D.). *A Broader Definition Of Riba*. Pakistan Institute Of Development Economics, Available At:

<URL:Http://Www.Pide.Org.Pk/Pdf/Psde%2018AGM/A %20Broader %20Definition%20Of%20Riba.Pdf>, Access Date: 3rd June 2008.

Iqbal, M. And Molyneux, P. 'Thirty Years Of Islamic Banking: History, Performance And Prospects' (2005). New York, Palgrave Macmillan

Iqbal, Z. And Mirakhor, A. (2003). Stakeholders Model Of Governance In Islamic Economic System, In The Fifth International Conference On Islamic Economics And Finance: Sustainable Development And Islamic Finance In Muslim Countries, Irti, Islamic Development Bank. Bahrain.

Iqbal, Z. And Mirakhor, A. (2004). Stakeholders Model Of Governance In Islamic. Economic System. Islamic Economics Studies. 11 (2), Pp. 43-63.

Jawahar I M, Mclaughlin, G L. 2001. Toward A Descriptive Stakeholder Theory: An Organizational Life Cycle Approach. Academy Of Management Review 26(3): 397-414.

J. H. Dunning, 'Making Globalization Good: The Moral Challenge Of Global Capitalism,' Oxford University Press, Oxford. 2003

Muhammad Nejatullah Siddiqi, 'Partnership And Profit-Sharing In Islamic Law'. Published By The Islamic Foundation 1985.

Jensen M C. (2000). Value Maximization, Stakeholder Theory, And The Corporate Objective Function. Business Ethics Quarterly 12(2)2: 35-256.

Jensen, M. C. And Meckling, W. (1976). Theory Of The Firm: Managerial Behaviour, Agency Cost, And Capital Structure, Journal Of Financial Economics 3: 305-360.

Jawahar I M, Mclaughlin, G L. 'Toward A Descriptive Stakeholder Theory: An Organizational Life Cycle Approach.' 2001 Academy Of Management Review 26(3): 397-414.

Johnson, H.L , 'Business In Contemporary Society: Framework And Issues.' (1971). Belmont, Ca: Wadsworth.

John Armour And Joseph A Mccahery; 'After Enron Improving Corporate Law And Modernising Securities Regulation In Europe And The Us'. Hart Publishing 2006.

Jones, T. M. (1995). Instrumental Stakeholder Theory: A Synthesis Of Ethics And Economics. Academy Of Management Review. 20 (1), Pp. 404-437.

Jones, T. M. And Wicks, A. C. (1999). Convergent Stakeholder Theory. Ficaeini' Of Management Review. 24 (2), Pp. 206-221.

John Armour And Joseph A Mccahery 'After Enron Improving Corporate Law And Modernizing Securities Regulation In Europe And The US'; HART PUBLISHING 2006.

Jones, T. M., Felps, W., And Bigley, G. A. (2007). Ethical Theory And Stakeholder-Related Decisions: The Role Of Stakeholder Culture. *Academy Of Management Review*, 32(1): 37-155.

Jones, T. M. 'Instrumental Stakeholder Theory: A Synthesis Of Ethics And Economics.' (1995). *Academy Of Management Review*. 20 (1), Pp. 404-437.

Joseph Mccahery, Sol Picciotto And Colin Scott; 'Corporate Control And Accountability Changing Structures And Dynamics Of Regulation'. Clarendon Press. Oxford 1993.

Joseph A.Mccahery, Piet Moerland, Theo Raaijmakers; 'Corporate Governance Regimes Convergence And Diversity', Oxford University Press 2006.

J. H. Dunning, 'Making Globalization Good: The Moral Challenge Of Global Capitalism,' Oxford University Press, Oxford. 2003

Jones, T. M. 'Instrumental Stakeholder Theory: A Synthesis Of Ethics And Economics.' (1995). *Academy Of Management Review*. 20 (1), Pp. 404-437.

Jones, T. M., Felps, W., And Bigley, G. A. 'Ethical Theory And Stakeholder-Related Decisions: The Role Of Stakeholder Culture.' (2007 *Academy Of Management Review*, 32(1): 37-155.

Jones, T. M. And Wicks, A. C. 'Convergent Stakeholder Theory.' (1999) *Ficadeini' Of Management Review*. 24 (2), Pp. 206-221.

Karnali, M. H. (1989b). Sources, Nature And Objectives Of Shari'ah. *The Islamic Quarterly*. Pp. 215-235.

Katharina Pistor And Curtis J. Milhaupt "Law And Capitalism: What Corporate Governance Crisis Reveal About Legal Systems And Economic Development Around The World", The University Of Chicago Press, Pp.47—68.

K.Eisenhardt, 'Control: Organisational And Economic Approaches' (1985). *Management Science*, 31, 134-49

Kay, J. And A. Silberston (1995). *Corporate Governance*. National Institute Economic Review 84,84-97.

K.M. Eisenhardt 'Agency Theory: An Assessment And Review'. (1989), *Academy Of Management Review*, 14: 57-74.

Karnali, M. H. (1993). Fundamental Rights Of The Individual: An Analysis Of Haqq (Right) In Islamic Law. *The Islamic Journal Of Social Sciences*. 10 (3), Pp. 340-366.

Kelly, G., Kelly, D., And Gamble, A. 'Stakeholder Capitalism,' (Eds.) (1997). Houndmills, Basingstoke: Macmillan.

Khan, M. A. (1990a) Glossary Of Islamic Economics, Mansel, London.

Khan, M. A. (1992) Islamic Banking In Pakistan: The Future Path. All Islamic Education Congress, Lahore, Pakistan.

Khan, M., Mirakhor, A. (1987) The Financial System And Monetary Policy In An Islamic Economy. A Paper On Theoretical Studies In Islamic Banking And Finance.

Kirkbride, James And Letza, Steve 'The CEO In Law And In Practice: A Study Of Categorisation And Control'.. Corporate Governance: An International Review, Vol. 10, Pp. 136-152, 2002. Available At SSRN: <http://Ssrn.Com/Abstract=314286>

Kitson, A. And Campbell, R. 'The Ethical Organization.' (1996). London: Macmillan.

Kochan, T. A. And Rubinstein, S. A. 'Toward A Stakeholder Theory Of The Firm: The Saturn Partnership,' (2000). Organization Science, 11(4): 367-386.

M. Khan And A. Mirakhor (Eds.). The Institute For Research And Islamic Studies, Houston, Texas, USA.

Khan, M. (1990b) 'Monetary Policy In An Islamic Economy'. Paper Prepared For The 6th Expert Level Meeting On Islamic Banking, Bahrain (May 26-28).

Khan, S. R. (1987) Profit And Loss Sharing: An Islamic Experiment In Finance And Banking. Oxford University Press, Karachi, Pakistan.

Karim, R. A. A., (1990a), The Independence Of Religious And External Auditors: The Case Of AAOIFI

Karim, R. A. A., (1990b), Standard Setting For The Financial Reporting Of Religious Business

Karim, R. A. A., (1994), Regulation Of Financial Reporting By Islamic Banks, In Accounting

Kahf, M. 'A Contribution To The Theory Of Consumer Behavior In An Islamic Society In Studies In Islamic Economics, (1981) Ed By K. Ahmad. International Centre For Research In Islamic Economics, King Abdul-Aziz University, Jeddah And Islamic Foundation, Leicester.

Issues In Islamic Banking, London: IIBI, Pp. 53-59

Karim, R. A. A., (1995), The Nature And Rationale Of A Conceptual Framework For Financial

- Karnali, M. H. (1999). *Maqasid Al-Shari'ah: The Objectives Of Islamic Law*. Islamic Research Institute, International Islamic University Islamabad. Islamabad.
- Kay, J. (1997). The Stakeholder Corporation, In: G. Kelly, D. Kelly And A. Gamble, (Eds.), *Stakeholder Capitalism*. London: Macmillan.
- Kelly, G., Kelly, D., And Gamble, A. (Eds.) (1997). *Stakeholder Capitalism*, Houndmills, Basingstoke: Macmillan.
- Kitson, A. And Campbell, R. (1996). *The Ethical Organisation*. London: Macmillan.
- Kochan, T. A. And Rubinstein, S. A. (2000). Toward A Stakeholder Theory Of The Firm: The Saturn Partnership, *Organization Science*, 11(4): 367-386.
- Korhonen, J. (2002). The Dominant Economics Paradigm And Corporate Social Responsibility. *Corporate Social Responsibility Environment Management* (9), 67-80.
- Kuran, T. (1995). Islamic Economics And The Islamic Subeconomy. *The Journal Of Economic Perspectives*. 9 (4), Pp. 155-74.
- Kuran, T. (2004). *Islam And Mammon: The Economic Predicaments Of Islamism*. New Jersey, Princeton University Press.
- L. Esposito 'The Oxford Dictionary Of Islam,' , Oxford University Press, New York, 2003,
- L. E. Mitchell 'The Speculation Economy: How Finance Triumphed Over Industry,' (2008), Berrett-Koehler Publications. USA
- Lawrence E. Mitchell, 'Progressive Corporate Law', Westview Press, 1995
- Llewellyn, D. 'The Economic Rationale For Financial Regulation.' (1999). The Occasional Paper Series No. 1. London, Financial Services Authority (FSA).
- Luca Errico And Mira Farhbaksh 'Islamic Banking: Issues In Prudential Regulation And Supervision'.; Imf Money And Exchange Department, Wp/98/30, Working Paper
- Lakoff, G., 'Moral Politics; What Conservatives Know That Liberals Don't.' 1996. Chicago: University Of Chicago Press.
- Lewis, M. K. And Algaud, L. M. (2001). *Islamic Banking*. Cheltenham, Uk, Edward Elgar.
- L. E. Talbot 'Critical Company Law',. Routledge- Cavendish, UK. 2008
- Louis J. Cantori And Arthur Lowrie "Islam, Democracy, The State, And The West," *Middle East Policy*, Vol. 1, No. 3 (1992), Pp. 49-61. 23.

Liaquat Ali Khan Niazi 'Islamic Jurisprudence Including Muslim Personal Law.'. Pg 16, Niaz Jhangir Printers, Lahore, Pakistan. 2009

Llewellyn, D. (1999). The Economic Rationale For Financial Regulation. The Occasional Paper Series No. 1. London, Financial Services Authority (Fsa).

Luca Errico And Mira Farhbaksh; 'Islamic Banking: Issues In Prudential Regulation And Supervision'. Imf Money And Exchange Department, Wp/98/30, Working Paper.

Maududi, Sayyid Abul 'Ala (Nd). The Meaning Of The Qur'an. Vol. 2. Delhi: Board Of Islamic Publications.

Nyazee, Imran Ahsan Khan (2000). The Concept Of Riba And Islamic Banking. Available At: <URL: <http://Www.Nyazee.Com/Islbanks/Riba/Riba.Html>> Access Date: 3rd June 2008.

M. Cherif Bassiouni 'Schools Of Thought In Islam,' De Paul University , JAN 24, 2012 <http://Www.Mei.Edu/Content/Schools-Thought-Islam>
M.E.Hamid, 'Islamic Law Of Contract Or Contracts,' Journal Of Islamic And Comparative Law. 3:1-11

M. Dodd 'For Whom Are Managers Trustees?' (1931-1932) 45 HarvL 1162.

Mark Blaug 'Economic Theory In Retrospect,' (Cambridge: Cambridge University Press, 1978).
Mark Roe "Strong Manager, Weak Owners: The Political Roots Of American Corporate Finance" Mark Roe (Princeton University Press (1994).

Maria.C.Ungureanu; 'Banks Regulation And Corporate Governance Framework', Ecgi. Journal Of Ownership And Control Volume 5, Issue 2, 2008;
[Http://Ssrn.Com/Abstract=1084042](http://Ssrn.Com/Abstract=1084042).

Machlup, F. (1967). Theories Of The Firm: Marginalist, Behavioural, Managerial. American Economic Review 42,1-34.

Manne, H. (1965). Mergers And The Market For Corporate Control. Journal Of Political Economy 73(2), 110-120.

Marris, R. (1964). The Economic Theory Of Managerial Capitalism. Macmillan, London.

Mawdudi, A. 'Economic System Of Islam,' Islamic Publication, Lahore(1984)

McWilliams, A. & Siegel, D. (2001). Corporate Social Responsibility: A Theory Of The Firm Perspective. Academy Of Management Review 2, 6(L): 7-127.

Mitchell, R., Agle, B., Wood, D. (1997). Towards A Theory Of Stakeholder Identification: Defining The Principle Of Who And What Really Counts. Academy Of Management Review 22(4), 853-86.

Mitnick, B.M, 'The Political Economy Of Regulation: Creating, Designing, And Removing Regulatory Forms.'1980. New York: Columbia University Press.

Mirakhor, A. (2000). General Characteristics Of An Islamic Economic System, In. A. Siddiqi, Anthology Of Islamic Banking, Institute Of Islamic Banking And Insurance, London. Pp. 11-31.

Mirakhor, A. (1988) The Progress Of Islamic Banking: The Case Of Iran And Pakistan In Islamic Law And Finance, C. Mallat (Ed.). Graham And Trotman.

Mitchell, R. K., Agle, B. R. And Wood, D. J. (1997). Toward A Theory Of Stakeholder Identification And Salience: Defining The Principle Of Who And What Really Counts. Academy Of Management Review. 22 (4), Pp. 853-886.

Mohammed. N 'Principles Of Islamic Contract Law', Journal Of Law And Religion Vol. 6, No. 1 (1988), Pp. 115-130.

M.H.Kamali 'Islamic Commercial Law: An Analysis Of Futures And Options,'. Islamic Texts Society, Cambridge, UK 2000

Moore, R. M. And N. Delener 'Islam And Work', 1986, In 'Workforce Management In The Arabian Peninsula, G. S. Roukis And P. J. Montana (Eds.), (Greenwood Press, Westport, CT)

Murat Cizakca 'Islamic Capitalism And Finance, Origins, Evolution And The Future.', 2011. Edward Elgar Publishing Limited.UK

Musa, M. And Salleh, S. M. S. S. M. (2002). The Concept Of Total Quality In Islam. Ikim Journal. 10 (1), Pp. 1-19.

Musa .Y 'Liberty Of The Individual In Contracts And Conditions According To Islamic Law. (1955), Arab Law Quarterly V II

M.Imran Usmani, 'Meezan Bank's Guide To Islamic Banking,' Darul Ishaat, Karachi Pakistan.2002

Nienhaus, Volker (2011): Islamic Finance Ethics and Shari'ah Law in the Aftermath of the Crisis: Concept and Practice of Shari'ah Compliant Finance, in: Ethical Perspectives, Vol. 18, No. 4, pp. 891-623.

Nasser M. Suleiman 'Corporate Governance In Islamic Banks', See [Http://Www.Al-Bab.Com/Arab/Econ/Nsbanks.Htm](http://www.Al-Bab.Com/Arab/Econ/Nsbanks.Htm)

Naqvi, S. N. H. (1981). Ethics And Economics: An Islamic Synthesis. Leicester, The Islamic Foundation.

Nickel And Dimed: On (Not) Getting By In America. Ehrenreich,B. 2001. New York Metropolitan Books.

- Naqvi, S. N. H. (2001). Economics, Ethics And Religion: A Rejoinder To Wilson. Review Of Islamic Economics. 10, Pp. 91-96.
- Naqvi, S. N. H. (2003). Perspective On Morality And Human Well-Being: A Contribution To Islamic Economics. Leicester, The Islamic Foundation.
- Noor Mohammed 'Principles Of Islamic Contract Law,' Source: Journal Of Law And Religion, Vol. 6, No. 1 (1988), Pp. 115-130Published By: Journal Of Law And Religion, Inc. Stable URL: [Http://Www.Jstor.Org/Stable/1051062](http://www.jstor.org/stable/1051062),Accessed: 17/09/2010 08:26
- Nicomachean Ethics By Aristotle 350 Bc Translated By W. D. Ross, Oxford University Press, Usa ,July 9, 1998.Pp 1099b
- Nyazee, I. A. K. (1994). Theories Of Islamic Law. Islamabad, Pakistan, Islamic Research Institute Press.
- Nyazee, I. A. K. (2000). Islamic Jurispudence (Usul Al-Figh). Islamabad, Islamic Research Institute Press.
- Obaidullah, M. (2004). A Comment On "Stakeholders Model Of Governance In Islamic Economic System". Islamic Economic Studies. 11 (2), Pp. 71-74.
- O'reilly, C. (1989). Corporations, Culture And Commitment: Motivation And Social Control In Organizations. California Management Review, 31(4): 9-25.
- Peter O. Mulbert; 'Corporate Governance Of Banks' [Http://Ssrn.Com/Abstract=1448118](http://ssrn.com/abstract=1448118) , Working Paper N:130/2009.
- Phillips, K, 'American Theocracy: The Peril And Politics Of Radical Religion, Oil And Borrowed Money In The 21st Century,' 2006. New York: Viking
- Phillips, R. A. (1997). Stakeholder Theory And A Principle Of Fairness. Business Ethics Quarterly. 7 (1), Pp. 51-66.
- Phillips, R. (2003). Stakeholder Theory And Organizational Ethics. San Francisco, Ca: Barrett-Koehler.
- Phillips, R. A. And Reichart, J. (2000). The Environment As A Stakeholder? A Fairness-Based Approach .Journal Of Business Ethics,2 3(2):1 85-197.
- Phillips, R., Freeman, E. And Wicks, A. C. (2003). What Stakeholder Theory Is Not? Business Ethics Quarterly, 13(4): 479-502.
- Phillips, R. A. (1997). Stakeholder Theory And A Principle Of Fairness. Business Ethics Quarterly7, 0): 51-66.
- Porter, M.E.; Kramer, Mark R, 'The Competitive Advantage Of Corporate Philanthropy.' (December, 2002). Harvard Business Review (Pp. 5-16).

- P. Ciarcanelli And J.A Reyes Gonzales;
 ‘Corporate Governance In Banking: A Conceptual Framework’
[Http://Papers.Ssrn.Com/Paper.Taf?Abstract_Id=253714](http://Papers.Ssrn.Com/Paper.Taf?Abstract_Id=253714).
- Pomeranz, F. (1995). Business Ethics: The Perspective Of Islam. The American Journal Of Islamic Social Sciences. 12 (3), Pp. 400-404.
- Popper, K.R., ‘The Poverty Of Historicism,’ 2nd Ed. London 1960.
- Principles Of Corporate Governance, Oecd (1999). Paris: OECD.
- Principles Of Corporate Governance, Oecd (2004a). Paris: OECD.
- P. W. F. Davies ‘Current Issues In Business Ethics,’ (1997) Routledge, London
- Racha Ghayad ‘Corporate Governance And The Global Performance Of Islamic Banking’, , Humanomics, 24: 3, 2008, Pp 207-16
- Reinhart, A. Kevin “Islamic Law As Islamic Ethics”, (1983), The Journal Of Religious Ethics, 11 (2), Pp 195
- Rice, Gillian ‘Islamic Ethics And The Implications For Business’ Author(S):
 Source: Journal Of Business Ethics, Vol. 18, No. 4 (Feb., 1999), Pp. 345-358
 Published By: Springer Stable URL: <http://www.jstor.org/stable/25074059>
 Accessed: 17/09/2010 08:36
- Robinson, J. ‘An Essay On Marxian Economics,’ Saint Martin's Press, New York. 1947
- Rodney Wilson ‘Legal, Regulatory And Governance Issues In Islamic Finance’, Edinburgh University Press , 2012
- Ronald Gilson, ‘Corporate Governance And Economic Efficiency: When Do Institutions Matter?’, 74 Wash. U.L.Q. 327, 331 (1996)
- Ross, S. (1973). The Economy Theory Of The Agency: The Principal's Problem. American Economic Review 63: 134-139.
- Rossauw, G.J. Business Ethics: Where Have All The Christians Gone?' 1994, Journal Of Business Ethics 13, 557-570.
- S. A. Ali ‘Economic Foundations Of Islam,’ (Calcutta: Orient Longmans, 1964),
- S.M.Hassanuzzaman, ‘Islam And Business Ethics,’ 2003, IIBI, London, UK
- Saiful Azhar Rosly ; ‘Critical Issues On Islamic Banking And Financial Markets’. Authorhouse 2005.

- Sarker, M. A. A. (1999). Islamic Business Contracts, Agency Problem And The Theory Of The Islamic Firm. *International Journal Of Islamic Financial Services*. 1 (2).
- Sattar, Z. (1988). The Ethics Of Profits In The Islamic Economic System: A Socioeconomic Analysis. *The Islamic Quarterly*. Xxxii (2), Pp. 69-76.
- Satkunasegaran, E. B. (2003). Corporate Governance And The Protection Of Customers Of Islamic Banks, In *International Islamic Banking Conference 2003*. Prato, Italy.
- Saeed, Abdullah. (1996). Islamic Banking And Interest: A Study Of The Prohibition Of Riba And Its Contemporary Interpretation. New York, E. J. Brill. *Review Of Islamic Economics*, Vol. 13, No. 1, 2009 141
- Saiful Azhar Rosly ‘Critical Issues On Islamic Banking And Financial Markets’. ; Authorhouse 2005.
- Saleh, Nabil A. (1986). *Unlawful Gain And Legitimate Profit In Islamic Law: Riba, Gharar And Islamic Banking*. Cambridge: Cambridge University Press.
- Schlossberger, E ‘ A New Model Of Business: Dual- Investor Theory’, (1994). *Business Ethics Quarterly*, 4/4: Pp 459-74.
- Sethi, P, ‘Up Against The Corporate Wall.’ 1971. Englewood Cliffs: Prentice Hall, Inc.
- Shafi, M.M. ‘Distribution Of Wealth In Islam,’ (1975). B. Aisha, Karachi
- Shehaby, Nabil. (1982). “Illa And Qiyas In Early Islamic Legal Theory”, *Journal Of American Oriental Society*, 102 (1), Jan-Mar, Pp. 27-46.
- Siddiqi, Mohammad Nejatullah (2004). “Riba, Bank Interest, And The Rationale Of Its Prohibition”, *Islamic Development Bank, Visiting Scholars Research Series*. Available At: <URL: [Http://Www.Globalwebpost.Com/Farooqm/Study_Res/I_Econ_Fin/Nejatullahs_Riba.Pdf](http://Www.Globalwebpost.Com/Farooqm/Study_Res/I_Econ_Fin/Nejatullahs_Riba.Pdf)>, Access Date: 3rd June 2008.
- Siddiqi, M. N. ‘Muslim Economic Thinking: A Survey Of Contemporary Literature’, 1981, In K. Ahmad (Ed.), *Studies In Islamic Economics* (The Islamic Foundation, Leicester).
- S.A. Cortright And M.J. Naughton, Eds., ‘Rethinking The Purpose Of Business.’ *Interdisciplinary Essays From The Catholic Social Tradition*. Notre Dame, In: University Of Notre Dame Press, 23-47.
- Schact, J. (1964). *An Introduction To Islamic Law*. Oxford, The Clarendon Press.
- Sen.A, , ‘On Economic Inequality,’ 1997. Oxford: Oxford University Press.

Shleifer, A. And R. Vishny (1997). A Survey Of Corporate Governance. *Journal Of Finance* 52,737-783.

Smith, A. (1776). *An Inquiry Into The Nature And Causes Of The Wealth Of Nations*. Black, Edinburgh.

Simon, H. 'Theories Of Decision Making In Economics.' (1959). *American Economic Review* 49,56-65

Simon Archer And Rifaat Ahmed Abdel Karim , 'Islamic Finance The Regulatory Challenge'.; Wiley Publishers (2007).

Simon Archer And Rifaat Ahmed Abdel Karim ; 'Islamic Finance The Regulatory Challenge'. Wiley Publishers (2007).

Siddiqui, M. N. (1984) *Banking And Monetary Policies In Economics*. A Pamphlet. Published By Faisal Islamic Bank, Saudi Arabia.

Siddiqui, M. N. (1986) 'Islamic Banking: Theory And Practice'. Unpublished Paper.

Siddiqui, M. N. (1987) *Partnership And Profit-Sharing In Islamic Law*. The Islamic Foundation, Leicester, Islamic Economics Series Number 9.

Siddiqui, M. N. (1988a) *Muslim Economic Thinking: A Survey Of Contemporary Literature*. International Centre For Research In Islamic Economics, King Abdul Aziz University Jeddah, Saudi Arabia And The Islamic Foundation, Leicester

Siddiqui, M. N. (1988b) *Banking Without Interest*. Islamic Education Series. The Islamic Foundation, Leicester.

Starik, M. (1994). What Is A Stakeholder? Essay By Mark Starik. Pp. 89-95 Of The Toronto Conference: Reflections On Stakeholder Theory, *Business Society* 33: 82-131.

Stark, A. (1993) What's The Matter With Business Ethics? *Harv Bus Rev.* 1993 May-Jun; 71(3): 38-40# 43-4,46-8.

Staw, B. 'Rationality And Justification In Organizational Life.' (1980). *Research In Organizational Behaviour* 2,45-80

Stephen Bainbridge "The Politics Of Corporate Governance", 18 *Harv. J.L. & Pub Pol'y* 671, 674 (1995)

Stone, A. 'Regulation And Its Alternatives,' 1982. Washington, Dc: Congressional Quarterly Press.

Sussman, M., & Vecchio, R. P. 1982. A Social Influence Interpretation Of Worker Motivation.. *Academy Of Management Review*, 7: 177-186.

Tarek Al Diwany 'Islamic Banking And Finance: What It Is And What It Could Be,' 1st Ethical Charitable Trust 2010

Thomas Philipp 'The Idea Of Islamic Economics,' Source: Die Welt Des Islams, New Series, Bd. 30, Nr. 1/4 (1990), Pp. 117-139 Published By: BRILL Stable URL: <http://www.jstor.org/stable/1571048> Accessed: 17/09/2010 08:27

T.L. Beauchamp And N.E. Bowie , 'Ethical Theory And Business,' 7th Edn. Upper Saddle River, Nj: Pearson/Prentice-Hall, Pp.55-64

Toutounchian, I.: Islamic Money And Banking And Its Comparison With Capitalism (In Persian); Tavangaran Press; Tehran,(2001).

Toutounchian, I.:" The Labor's Share Of Income In An Islamic Framework: A Proposal"; Humanomics; Vol.14, No.4 & Vol.15, No.1; 1989/9; Pp.136-165.

The Holy Qur'an. English Translation Of The Meanings And Commentary. King Fahd Holy Qur'an Printing Complex, Saudi Arabia, 1410H.

Thomas Clarke, 'Theories Of Corporate Governance: The Philosophical Foundations Of Corporate Governance,' Routledge.UK. 2004

T.R Macey And M.O'hara; 'The Corporate Governance Of Banks' Frbny Economic Policy Review, April 2003.

Udovitch, A. L., Partnership And Profit In Medieval Islam, Princeton 1970.

Usmani, M. T., (Winter 1996/1997), Shariah Governance Of Investment Funds, The American Journal Of Islamic Finance, Vol. Vii, No. 1, Pp. 13-20.

Usmani, M. T. (2000). An Introduction To Islamic Finance. Karachi, Pakistan, Idaratul Ma'arif.

Vogel, Frank And Hayes, Samuel (1998). Islamic Law And Finance: Religion, Risk And Return. The Hague: Kluwer Law International.

Votaw, D And P.Sethi, 'The Corporate Dilemma: Traditional Values Nersus Contemporary Problems.' 1974. Englewood Cliffs: Prentice Hall Inc.

W.T. Allen , Our Schizophrenic Conception Of The Business Corporation., Cardozo Law Review 14(2); 261-268(1992)

Wafik Grais And Matleo Pellegrini: 'Corporate Goevrnance And Shariah Compliance In Institutions Offering Islamic Financial Services'. World Bank Policy Research Working Paper 4054, November 2006.

Williams, B., (1972), Morality: An Introduction To Ethics, Uk: Cambridge University Press.

World Bank Seminar ,I'slamic Finance: Opportunities, Challenges And Corporate Governance Issues', , Washington, 24 April 2006.

Wood, D.J, Logsdon, J.M, Lewellyn, P.G., And Deavenport,K, 'Global Business Citizenship: A Transformative Framework For Ethics And Sustainability Capitalism.' 2006. Armonk, Ny: M.E.Sharpe.

Wijnberg, N. M. (2000). Normative Stakeholder Theory And Aristotle: The Link Between Ethics And Politics. *Journal Of Business Ethics*. 25, Pp. 329-342.

Wilson, A. (1997). Business And Its Social Responsibility, In. P. W. F. Davies, *Current Issues In Business Ethics*, Routledge, London.

Wilson, R. (1997). Economics, Ethics And Religion: Jewish, Christian And Muslim Economic Thought. London, Macmillan Press Ltd.

Wilson, R. (1997). Islamic Finance And Ethical Investment. *International Journal Of Social Economics*. 24 (11), Pp. 1325-1342.

Wilson, R. (2001). Business Ethics: Western And Islamic Perspectives, In. K. Ahmed And A. M. Sadeq, *Ethics In Business And Management: Islamic And Mainstream Approach*, Asean Academic Press, London.

Wilson, R. (2003). Parallels Between Islamic And Ethical Banking, In Paper Presented In Islamic Capital Market Task Force Of Malaysian Securities Commission Meeting. Melbourne, Australia. [Http: //Www. Sc. Coni. Niy/Htnil/affairs/Ioscoislamicpdf/Parallels. Pdf.](http://www.Sc.Coni.Niy/Htnil/affairs/Ioscoislamicpdf/Parallels.Pdf) , Accessed On 12 December 2010.

Windsor, D. (2001). The Future Of Corporate Social Responsibility. *International Journal Of Organizational Analysis*. 9 (3), Pp. 225-256.

Wood, D. J. (1991). Corporate Social Performance Revisited. *Academy Of Management Review*. 16 (4), Pp. 691-718.

Yousef, T. M. (2004). The Murabaha Syndrome In Islamic Finance: Laws, Institutions And Politics, In. R. Wilson, *The Politics Of Islamic Finance*, Edinburgh University Press, Edinburgh. Pp. 63-80.

Yvon Pesquex And Salma Damak-Ayadi, 'Stakeholder Theory In Perspective,' *Corporate Governance*: 2005; 5, 2.

Zamir Iqbal And Abbas Mirakhor; 'An Introduction To Islamic Finance Theory And Practice'. Wiley Publishers 2007.MKJ

Zaman, S. M. H. (1994). Practical Options For Central And Commercial Banking, In K. Ahmad, *Elimination Of Riba From The Economy*, Institute Of Policy Studies, Islamabad. Pp. 197-216.

Zaman, S. M. H 'Economic Functions Of An Islamic State: The Early Experience.'. (1991) The Islamic Foundation, Leicester.

